H.R. 3615; THE MUTUAL BANK CONVERSION ACT

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS SUPERVISION,
REGULATION AND DEPOSIT INSURANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

JANUARY 26, 1994

Printed for the use of the Committee on Banking, Finance and Urban Affairs

Serial No. 103–111

U.S. GOVERNMENT PRINTING OFFICE

76–097 CC WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-044075-0

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H.R. 3615; THE MUTUAL BANK CONVERSION ACT

WEDNESDAY, JANUARY 26, 1994

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND DEPOSIT INSURANCE,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to call, at 10:15 a.m., in room 2128, Rayburn House Office Building, Hon. Stephen L. Neal [chairman of the subcommittee] presiding.

Present: Chairman Neal, Representatives Vento, Kennedy, LaRocco, Orton, Klein, Maloney, Barrett, McCollum, Pryce, Lazio, and Huffington.

Chairman NEAL. I would like to call the subcommittee to order at this time.

The subcommittee meets this morning to continue its hearings on H.R. 3615, the Mutual Bank Conversion Act, and on the issue of mutual-to-stock conversions of savings banks generally.

Last Thursday, the subcommittee held a field hearing in Winston-Salem, North Carolina, and heard testimony from depositors, bankers, and State regulators. Much of the testimony gives rise to concerns that the insiders at mutual savings banks, unless adequately supervised, can take advantage of their position and unfairly profit from converting an institution from mutual-to-stock form, and especially in those instances where the conversion is a merger conversion.

More than 2 months ago, we wrote to the Federal Deposit Insurance Corporation asking it to take a more active role in regulating these transactions. They have issued a policy statement which was criticized by Board member and Comptroller of the Currency, Eugene Ludwig, and our full committee chairman—and I understand that the FDIC will have some thoughts this morning on a little different approach, and I look forward to hearing those.

In an interesting development, New York State Banking Superintendent Derrick Cephas just yesterday took some strong action after he determined that the trustees of Green Point Savings Bank would receive, and I quote, "excessive personal benefits . . . that were inconsistent with New York law." As a result of Superintendent Cephas' actions, the trustees and executive officers of Green Point will receive no free stock, or even be able to purchase stock in Green Point as a part of the conversion.

Superintendent Cephas was due to be one of our witnesses this morning. Due to the need to continue to work on supervision of the

Green Point conversion, he is unable to appear, but has indicated that he will submit a written statement for the record.

We will hear from a depositor of Green Point who opposed the conversion as proposed. Management of Green Point was invited to appear as well, but declined, citing concerns over ongoing litigation.

There have been mutual-to-stock conversions in other States that have raised concerns. In one transaction, Mutual Savings Bank of Milwaukee proposes to convert from a State-chartered mutual savings bank to a mutual holding company owning virtually all of the stock of the bank itself. The only stock in the savings bank to be sold will be offered solely and exclusively to 10 officers and directors. Depositors will be unable to purchase a single share of stock. Additional stock will be put into an employee stock ownership plan. The transaction would bring $2.3 million into the bank, while costing the bank $17.8 million. In short, this proposed transaction not only cuts depositors out, but reduces capital in the institution. This is a transaction that could not be done under current OTS regulation.

While there have been a number of transactions approved by State regulators in several States that appear quite outrageous, there are questions about the appropriate Federal legislation. Actually, it seemed like a pretty clear-cut issue when we were first presented it; it seems a little bit more complicated now. It may very well be that conversions from mutual-to-stock are quite reasonable and productive, and fair to everyone concerned if depositors are able to buy stock on the same terms as anyone else, or essentially the same terms.

There do seem to be some problems with these so-called merger conversions because of the different treatment and the concerns of different people. Anyway, we continue to explore the issue and try to find what is sensible, and I look forward to our witnesses' testimony this morning.

Before hearing from them, let me yield to the distinguished minority leader of the subcommittee, Mr. McCollum.

Mr. McCOLLUM. Thank you very much, Mr. Chairman.

I could not let the opportunity pass at this first hearing since you made your announcement that you were to retire, that we very much regret that fact. I have had the pleasure of working with you in a position of chairman and ranking member on a number of occasions over the past few years, and, frankly, you are one of the best in terms of working on a bipartisan basis, in terms of getting results, that I have ever had the privilege of working with.

So I am especially disappointed to see that you have chosen to retire now, though I understand at some point we all do that. You are going to be missed though, at least by this member, and I am sure I speak for all of the members of this subcommittee and the full committee.

Chairman NEAL. Thank you.

Mr. McCOLLUM. You are more than welcome.

Unfortunately, Mr. Chairman, I am going to have to leave to do some things that I had previously scheduled and won't be able to sit through all of the hearing, but I do look forward to reading the testimony and studying it today.

It seems that we have reignited some State law versus Federal regulations issues in this question, and I think it is going to be important that those who are here today help us clarify those issues so that we can make the right legislative judgment regarding the conversion. I am looking forward to finding out specifically how OTS manages the Board of Directors compensation and what benchmarks they use to determine what is excessive.

I would also welcome a comparison to corporate executive compensation; how much say do corporate stockholders have in the determination of executive salaries; how do proxy procedures compare, and if this is an appropriate analogy to make, given the nature of financial institutions.

I think we should remember that not too long ago Congress was preaching the salvation of the thrift industry in seeking to avoid further bailout. This is a situation where it is obvious that some thrifts, recognizing their weaknesses and strengthening their positions by merging with other institutions are changing to stock ownership. While I want to do what is right to help regulation in this area, I would not want to see us pass any legislation that would keep appropriate stock conversions from occurring, or to discourage those who really should be doing that type of activity to strengthen their position.

So all of those questions is I think what this hearing is about. I thank you for holding it, and I regret, again, that I won't be able to be here for much of it, but I am very interested and I am going to follow it closely.

Chairman NEAL. Thank you, sir, very much.

Are there others who would like to make any opening comments?

Mr. KENNEDY. I just want to make a brief opening comment, echoing on one of the themes that Mr. McCollum just mentioned.

Steve, I think many of the members that I have served with on this subcommittee, you have brought as important a balance to the issues that we have faced, and I really believe that Congress loses a very special person when you announced that you are going to retire. I know that we still have a year to work together, and there are going to be a lot of important issues that the subcommittee faces, but nevertheless, I just want to say how much I have appreciated the efforts that you have made to try to understand all the sides of an issue.

I think that on many—most controversial issues, when I first came to serve on this subcommittee, particularly dealing with the savings and loan crisis, you never hesitated to ask questions that oftentimes enlightened many of the younger members of the subcommittee. So I just want to thank you very much for all of the leadership and friendship that you have shown to me and tell you how sad I am that you are leaving the Congress, how much I think that the people of our country will miss you; but on the other hand, I hope that you gain some real personal happiness from your decision.

Chairman NEAL. Thank you.

Mr. KENNEDY. I just want to say how much I appreciate all of your efforts.

Chairman NEAL. Thank you, my friend.

Yes, sir.

Mr. KLEIN. Steve, I, too, would like to join in the sentiments expressed by Mr. McCollum and Joe Kennedy. I am not going to repeat all of those. I certainly join in everything that has been said about your leadership and your fairness, but I would like to express a particular thought as a freshman member of this subcommittee.

You know, when I came to Congress I had been told a lot of stories about the fact that freshmen would have very little opportunity to participate in the work of the committees and in the work of Congress. And certainly my experience has been exactly the opposite on this particular subcommittee. You have not only been a terrific friend and a terrific leader, but you have been a wonderful mentor and you have been absolutely great to me and to other freshmen members in giving us an opportunity to play a meaningful role, and I just want to express my very, very sincere and personal thanks to you.

Chairman NEAL. Thank very much.

Mr. Barrett.

Mr. BARRETT. Mr. Chairman, I know I sound like I am giving a eulogy too, but it has been a pleasure to serve under you. You have done a great job. I have a brief opening statement concerning the issues of the day, if I could.

Again, thank you for holding this hearing on this very important topic. I thank Mr. Harold Lee, from my State of Wisconsin, for being here today, as well as the other witnesses.

Mutual savings banks are rapidly converting to stock form of ownership outside the scrutiny of Federal law, so Congress is rightfully concerned about this area of transactions, as it may ultimately affect the financial services available to the American public. This issue is particularly important, because many State laws—States lack adequate laws governing mutual bank conversions.

Unfortunately, insider abuse does exist and it is our obligation to end those abuses and to ensure that conversions treat all investors and all depositors fairly. I support the goal of the Conversion Act which seeks to apply a Federal-existing safeguard to State-chartered mutual bank conversions and to prevent any potential abuses on the part of insiders and acquirers of mutual banks.

Not only mutual bank conversion is guilty of these transgressions, so I am pleased that this legislation does not seek to eliminate these conversions. It simply makes sure that they occur in the full light of day and that they are fair to all parties involved.

Thank you.

Chairman NEAL. Yes, sir.

Mr. LAROCCO. Mr. Chairman, I just want to add my voice to those of our other colleagues here in this forum and in this subcommittee to thank you for all of your contributions to this subcommittee and the Congress, and especially the friendship that you have showed me as a new Member in 1991 coming to this body. You sought out my opinion on many issues dealing with banking as a new Member and I appreciated that, and on some of the issues that I weighed in on, I found that Steve Neal had plowed away in Congresses and in years before, and you have a great reputation on this subcommittee and in the country as a whole, Steve, and I just wanted to thank you for your leadership.

Chairman NEAL. Thank you, my friend.

Let me tell you, all of you, I appreciate those kind comments. I have very mixed feelings about leaving, because I love this place and I love the people and I love my constituents and I love our system. I have no complaints. I just think it is a fabulous institution, a fabulous place. I will have been doing it 20 years, and it seems to me the time is right. But anyway, I appreciate all of your fine comments and your very fine friendship.

Yes, sir.

Mr. ORTON. Thank you, Mr. Chairman.

I also would just like to add my voice. You being one of the first people that I came to know here on the committee, I appreciate the assistance that you have given me. You have really brought intellect, leadership, and fairness to the subcommittee, and I think it is very few people who would exhibit the kind of openmindedness and fairness that you continually exhibit, this hearing not being an exception.

You always want to hear both sides of every issue, not just asking witnesses who support or endorse a particular program that you are working on, but always wanting to hear both sides, and I think you have always given everyone an opportunity to be fully heard and participate in the process, and that certainly reflects your intellect and fairness. And I appreciate you very much, and you will be missed next year.

We look forward to your leadership, however, throughout this year. There are many things that we can and must accomplish, and I know you have an agenda to do that.

Chairman NEAL. Thanks. Well, we do have a busy year. I appreciate all of your thoughts and help.

I now would like to welcome our first panel, Mr. Jonathan Fiechter, Acting Director, Office of Thrift Supervision, and the Honorable Andrew Hove, Jr., Acting Chairman, Federal Deposit Insurance Corporation.

Gentlemen, I thank you very much for coming. We will put your entire statements in the record and look forward to your summaries of your testimony.

Mr. Fiechter, do you want to proceed?

STATEMENT OF JONATHAN L. FIECHTER, ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. FIECHTER. Good morning, Mr. Chairman and members of the subcommittee.

I appreciate the opportunity to present the Office of Thrift Supervision's views on regulating mutual-to-stock conversions and want to compliment you, Mr. Chairman, on initiating hearings on this issue. The thrift industry has changed dramatically since hearings were last held on this subject, and it is important that our policies and regulations, which were developed in the 1970's, be in accord with the current environment.

For the past 20 years, since the former Federal Home Loan Bank Board implemented its conversion regulations in 1974, mutual-to-stock conversions have been a successful vehicle for bringing new capital into the thrift industry. Since 1974, over 1,000 mutual sav-

ings associations have converted to the stock form of ownership, in the process raising $16 billion in new capital.

As these numbers suggest, a principal benefit of an institution converting from the mutual to the stock form is raising capital, a result that can otherwise be difficult for mutuals to achieve. Mutual associations can increase their equity base only from retained earnings. This can be a lengthy process.

Often, a mutual-to-stock conversion by a healthy institution results in a quick appreciation in the value of the stock. This makes the transaction attractive to the institution's insiders because of the opportunity for those insiders to realize a profit, often a substantial profit, on the stock they purchase in the conversion transaction. This aspect of the transaction has recently drawn a great deal of attention. It is, as I will shortly discuss, one of the focal points of OTS regulation. I believe it would be useful to begin, however, with an overview of the mutual-to-stock conversion process.

The decision to convert a mutual institution is typically initiated by the institution's board of directors. The institution's directors adopt a plan of conversion, file an application, and notify the institution's account holders.

The conversion application, filed with the regulator, usually includes a plan of conversion, a copy of the proxy statement to be sent to account holders, and an offering circular registering the conversion stock. In addition, the institution is generally required to provide some form of valuation of the conversion stock.

If the conversion application receives regulatory approval, the plan of conversion is usually submitted to a vote at a special meeting of account holders. In most cases, a majority of the total outstanding votes of account holders is required to approve the plan. Account holders may vote in person or by proxy.

In the conversion process, priorities and incentives are typically established with respect to the purchase of conversion stock. Priority purchase rights may be extended to account holders, the institution's officers and directors, employee stock benefit plans, and to members of the general public residing in the communities where the association has offices.

I would like to now give a brief history of the Federal conversion rules.

Prior to 1948, all savings associations operated as mutual associations. When Congress authorized savings associations to convert from mutuals to the stock form in 1948, concerns were immediately raised regarding conversions and the distribution of the net worth of the mutual institution among potential owners of the new stock.

As a result, the Federal Home Loan Bank Board and Congress imposed various moratoria on conversions and only a small number of conversions were actually completed. In an effort to address these concerns, the Federal Home Loan Bank Board proposed conversion regulations in 1973. Both the Bank Board and the Congress held hearings on the regulations and the need for legislation in this area. Following these hearings, the Bank Board issued regulations in 1974.

It was generally believed that the new regulations adequately addressed the problems arising from conversion windfalls. As a re-

sult, Congress allowed its conversion moratorium to expire on June 30, 1974. This regulation continues in effect today.

The conversion from a mutual form of ownership to stock ownership creates several concerns. In a mutual-to-stock conversion, the mutual's insiders, its directors and managers, are the parties who initiate and set the terms for the sale of the stock. But they are also potential purchasers of the stock. They, like any purchasers, are motivated to buy low in order to maximize the stock's value to them in the aftermarket. The account holders who have an ownership interest in the mutual institution are also potential stock purchasers. As such, they too will benefit from the stock's appreciation in the aftermarket.

Thus, when a mutual institution converts to stock form, the transaction is one-sided. There are "typically motivated" buyers for the stock, but in a mutual conversion there are no "typically motivated" sellers. The market does not exert discipline over the transaction—the usual tension between seller and buyer is lacking.

It is this absence of market discipline that is most troublesome and creates the potential for abuse. OTS regulations are designed to counteract this tendency by imposing limits or controls on insiders' activities in connection with mutual-to-stock conversions. To receive OTS approval, an institution must meet the following conditions: (a) Specific subscription priorities must be established that give first priority, after any tax-qualified ESOP purchases, to savings account holders with the institution at least 90 days prior to the date of adoption of the plan of conversion. Only then may a priority be established for management and employee stock purchases.

(b) Purchases by officers and directors in the aggregate are limited to between 25 percent and 35 percent of the total conversion stock offering, depending on the asset size of the institution.

(c) The conversion stock must be sold at a price equal to the estimated pro forma market value of the converting institution's stock based on an independent valuation. The appraisal is reviewed by the OTS to ensure there is adequate data to support the estimated pro forma market value, for conformity with appraisal methodology and documentation standards, and to verify the appraiser's experience and independence.

The OTS conversion regulations, which are comprehensive in scope and govern all aspects of the conversion process, set forth specific and detailed standards that have been consistently imposed without exception as regulatory requirements in conversion standards over the years. These key regulatory controls are consistent with our understanding of the purpose and objectives of congressional intent in allowing the mutual-to-stock conversion moratorium to expire in 1974.

Mr. Chairman, the nature of mutual-to-stock conversions and the dynamics of the marketplace make it difficult to write regulations in this area. In administering the Conversion Program, the OTS continuously reviews the need for further changes to its rules. OTS has revised the conversion regulations several times since 1974 and remains open to any suggestions for further improvements to its rules.

We continue to believe that minimum regulatory standards in the conversion area are desirable to curb the potential for abuse inherent in the skewed economic incentives in mutual-to-stock conversions. If such conversion standards are appropriate for OTS-supervised mutuals, they are presumably appropriate for other mutual institutions that convert.

A number of States do follow closely the Federal conversion rules. Some, however, do not. Differences in those States that do not follow the Federal rules primarily involve: The rights of mutual account holders to purchase conversion stock; the amount of conversion stock that institution insiders may purchase; the amount of stock incentives that may be given to management; and the valuation of the conversion stock.

The 1989 FIRREA legislation provided the authority for a SAIF-insured savings association to become a State savings bank. Increasingly, mutual institutions that are choosing to convert to stock form find it advantageous to do so under State rules. Over the past several years, the number of OTS-supervised mutual institutions that have changed to State savings bank charters has increased dramatically.

For example, 51 North Carolina mutual institutions recently removed themselves from OTS jurisdiction in favor of North Carolina's State savings bank charter. Of these, nearly half subsequently undertook a conversion to stock form. During the same time, only two North Carolina mutuals supervised by the OTS undertook similar conversions. Similar patterns exist in Pennsylvania, Wisconsin, and New Jersey.

Of course, differences in Federal and State conversion standards are not the only incentives for OTS-supervised thrifts to change charters. Institutions changing charters can save on supervisory expenses. OTS-supervised thrifts are required to hold stock in the Federal Home Loan Bank System. Thrifts that change to State savings banks may redeem their Federal Home Loan Bank stock.

In conclusion, Mr. Chairman, mutual-to-stock conversions do provide an opportunity for an institution to raise capital. Mutual-to-stock conversions, however, may also tempt an institution's insiders to engage in transactions that transfer an inappropriate amount of the institution's value to the institution's insiders.

The OTS mutual-to-stock conversion regulations reflect standards and safeguards developed over the years to counteract the lack of market discipline in the process, and to respond to the potential for abuses in thrift conversions. Some of these standards are not being applied to conversions of institutions not supervised by the OTS.

We do not believe there is a compelling reason to permit what amounts to "regulatory arbitrage" that may disadvantage depositors or their local communities. To the extent that standards are necessary to guard against abuses in the conversion process, these standards should be consistent. The issue is not OTS rules versus State rules, but identifying what abuses, if any, exist and applying uniform rules.

Thank you.

[The prepared statement of Mr. Fiechter can be found in the appendix.]

Chairman NEAL. Well, thank you, sir, very much.

Now we would like to hear from Mr. Hove.

STATEMENT OF ANDREW HOVE, JR., ACTING CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. HOVE. Mr. Chairman, and members of the subcommittee, on behalf of the Federal Deposit Insurance Corporation, I appreciate this opportunity to testify regarding institutions that convert from mutual to stock ownership. We share your concern regarding the need to assure that the value in institutions that convert is fairly distributed. Depositors should be treated fairly and insiders such as management, trustees, and employees should not obtain a disproportionate share. When an acquisition by another institution is part of the conversion, depositors need to be treated fairly in relation to the interests of both the insiders and the acquiring institution.

At this point the FDIC is looking for a better understanding of this issue and we would welcome your guidance. This is clearly a public policy issue; namely, depositor fairness. We would also like to point out that many conversions, particularly those by marginally undercapitalized institutions, raise much needed capital that benefit the banks, the deposit insurance fund, and the public at large. It is important that we do not place unnecessary roadblocks to these worthwhile conversions where capital is deficient.

We at the FDIC see ourselves as guardians of depositors, so we share your concern that the conversion process may not be fair to depositors of mutual institutions. We are not sure we have clear statutory authority to completely remedy that unfairness, but the Congress can change that, if necessary. What we want to focus on is not narrow jurisdictional issues, but the public policy problem that clearly calls for attention. The problem is that under current economic and market conditions, conversion creates a windfall, and it isn't going to depositors.

A few years ago when many mutual institutions were undercapitalized and the stock market feared for the survival of the thrift industry, the conversion rules developed by State and Federal regulators created much less of a windfall. The buyers of stock in converting institutions were often saving those institutions from failure. Absent conversion, such institutions had minimal economic value. Buyers of stock received economic value approximately equal to what they had paid. Yes, the price of the new shares tended to rise from the initial offering price, but that often happens in initial public offerings.

In today's economic and market environment, conversions are creating very significant windfalls. Well-capitalized institutions, which the market regards as having significant economic value even before any new money goes in, are being converted. Buyers of the stock receive economic value equivalent to what they had paid, plus the value that was already there.

In some cases, officers and directors of the converting institutions are capturing that windfall. But merely writing regulations to prevent this kind of "insider abuse" will not remedy the fundamental problem, which is that depositors are not getting the windfall. If "insiders" can't benefit, it will be sophisticated investors who do,

not long-term depositors. Such depositors often lack the funds to participate in the offering, or do not want to put their savings into the stock market. Others who have the money and are able to risk it, buy the stock and get the windfall.

I have directed my staff to conduct a thorough review of the conversion process, which once worked fairly well but no longer does. Without getting into the details, we believe the conversion process should probably include the three following points.

Number one: The issuance to depositors of negotiable stock purchase rights, which they can sell in order to capture the windfall, rather than needing to put up new money.

Number two: A procedure whereby anyone, a potential acquiror or investor, who wants to purchase a depositor's rights can tender for them, subject to appropriate disclosure and procedures.

Number three: There should be an independent financial advisor who will act for depositors and on their behalf. And that financial advisor should be paid for by the institution.

Finally, as you know, the FDIC Board on January 24, 1994 approved the issuance of a 45-day request for comment on all aspects of the mutual-to-stock conversion subject. In brief, the proposed policy statement focuses on areas of potential abuse in conversion transactions: Pricing the shares; apportioning the stock subscription rights; and disclosure of information needed to make an informed investment decision. We are asking for comment on whether or not State oversight is sufficiently uniform and adequate across States to protect the interests of the public, or whether Federal oversight is necessary; whether abusive practices are prevalent or likely; and whether and why the FDIC should take action; and, whether the proposed policy statement contains enough specificity to be effective in providing worthwhile guidance. Comments are also requested as to whether mutual-to-stock conversions should be governed by an enforceable regulation, and if so, should such a regulation closely follow the existing regulation of the OTS that contains a large degree of specificity, or should it more closely resemble a guidance format as embodied in the proposed policy statement.

We look forward to working with this subcommittee and the Office of Thrift Supervision on this issue, and I would be happy to respond to questions. We are willing to participate at Congress' direction in reengineering this process.

Thank you very much.

[The prepared statement of Mr. Hove can be found in the appendix.]

Chairman NEAL. Thank you, sir, very much.

In trying to understand this, I can certainly see advantages to everyone concerned, I think, in conversions from mutual-to-stock. The institution can become stronger because it becomes better capitalized, and the problem appears to occur when there is a conversion merger, and I guess we wouldn't have paid any attention to this, except that the benefits to so-called insiders seems so, in some cases, so very high.

Now, that doesn't occur under the OTS rules. What would be wrong with just adopting OTS rules, applying OTS rules to all institutions? I mean that seems fairly simple. Is there a flaw in that?

Mr. FIECHTER. My position is that I think that we ought to have uniform standards applying to any institutions that convert. I wouldn't want to hold up our rules, however, Mr. Chairman, as being perfect. I think that there are certainly areas in our rules where we could make improvements. I am also—I think that the uniform standards—I am not certain whether I understood your comment—I think they need to apply both to traditional mutual-to-stock conversion, as well as to merger conversions.

I think that issues arise in both transactions. I think the issues are much greater in merger conversions, but I think there also are some—the traditional mutual-to-stock related to how much the insiders are able to purchase of that stock.

Chairman NEAL. Under your rules, how much are they able to purchase?

Mr. FIECHTER. Under our rules, we set a limit that management cannot directly purchase more than 25 to 35 percent of the stock, 25 percent of the stock in the case of the larger institutions, if it is over $500 million. For smaller institutions where you might not get the same market for the stock, and by smaller we define that as below $50 million, management can buy as much as 35 percent of the stock that is converting.

Chairman NEAL. Of course, in a large deal like this—now, what size was this New York deal?

Mr. FIECHTER. It was, I think, in the range of $5 or $6 billion.

Chairman NEAL. So I am told it is a $6 billion institution, so 25 percent of that is a whole lot of money.

Mr. FIECHTER. Well, it is. But there is another important feature of our regulations, which is that the depositors are given the first priority in purchasing the stock.

Chairman NEAL. Well, then——

Mr. FIECHTER. So that management could only buy that 25 percent if the depositor didn't buy it.

Chairman NEAL. Well, again, I wasn't trying to hold up all of your rules and regulations as being ideal either, but on this one subject—in fact, as I understand it, North Carolina regulators adopted all of your rules and regulations except this one, and this one is the controversial one for them, and for you, though—for both of you, what is your opinion on this one subject? Is this the right approach, to limit—well, to give the depositors a first priority to buy stock and then limit what others could buy so that people in the community have a chance to buy and so on? That seems reasonable to me.

Mr. FIECHTER. Yes. I agree with you.

Chairman NEAL. Is that the right approach? What do you say, Mr. Hove?

Mr. HOVE. I agree. I think that the issue really is the issue of fairness, and what is the fair amount? And then also, an understanding by the depositors of what the value is that they have got, because so many depositors, as much disclosure as you give them, simply pay no attention to that disclosure and pass up the value that probably belongs to them and they don't take advantage of that.

Chairman NEAL. So you are saying make the disclosure statements simpler?

Mr. HOVE. Make the disclosure statement simple so that it is understandable. Also, I think it is important for the depositor to have an understanding that probably could be provided by an independent investment advisor acting on behalf of the depositors.

Chairman NEAL. Of course, now if the appraisals are correct, then you shouldn't get that initial runup in the stock price, should you? I can't understand why the appraisals are so far off.

Why is the appraised value different from the market value, when they are both values that are established within a few days or weeks of each other? That doesn't make sense to me. That tells me that the appraisal value is wrong in many cases.

Mr. FIECHTER. I think there is an—I believe, Mr. Chairman, that any time a company, it isn't just mutual thrifts, any time you have a new stock offering, even if it is a company that makes tennis shoes——

Chairman NEAL. Yes, but they aren't appraised. Those stock offerings—I mean they are appraised in a way, but they are not appraised in this way.

Mr. FIECHTER. There is attritional runup when a company goes public with its stock. It is very difficult. It is not uncommon to have an independent appraisal come into OTS. We raise questions and the price is moved up.

In offering the stock, you never want to overprice the stock such that the process doesn't work. I think there is a natural tendency to err on the side of undervaluing.

Chairman NEAL. One other question and then I will yield to you.

You said that you were trying to interpret the intent of Congress, Mr. Hove. How did you come out on that? What was your conclusion? What was the intent of Congress?

Mr. HOVE. What we are trying to do is to establish a process where we can review these applications on State institutions that go to their State regulators. We would have our staff review these for the appropriateness, to see if, in fact, disclosures have been made and to see if insiders are taking an inappropriate amount.

Chairman NEAL. May I just—in the interest of time, did you find that North Carolina and Wisconsin, for example, and some other States were consistent with the intent of Congress?

Mr. HOVE. In our testimony, we have compared five States. Many of them compare very favorably with the rules that are set out by the OTS. And, as you pointed out, North Carolina, the difference is in the amount that the insiders can hold or the amount that the insiders can acquire. The rest of the regulations in North Carolina are very similar.

In fact, Wisconsin has been very different. However, it is my understanding that Wisconsin has a proposal that will bring their rules very much in line with the rules that the OTS now uses.

Chairman NEAL. But in trying to determine if they were previously consistent with the intent of Congress, what was your conclusion?

Mr. HOVE. Wisconsin has been somewhat different than the intent of Congress.

Chairman NEAL. Could you summarize the intent of Congress on this subject of executive compensation and so on?

Mr. HOVE. I am not sure I understand—has Congress spoken on the issue?

Chairman NEAL. Yes. I am asking you if Congress has spoken on this question.

Mr. HOVE. No. Not to my knowledge.

Chairman NEAL. You couldn't find it, anyway?

Mr. HOVE. No.

Chairman NEAL. OK. You had said in your testimony that you were trying to determine the intent of Congress on these subjects, and I just wondered if you had. I am not aware of the legislative history; that is why I am asking.

Mr. HOVE. No. It is not my understanding that you have. I guess what we are trying to do is to come to something that is reasonable, that is going to be reasonable for the depositor, and also reasonable for other investors.

Chairman NEAL. Thank you. Ms. Pryce.

Ms. PRYCE. I have nothing. Thank you, Mr. Chairman.

Chairman NEAL. OK. Mr. Kennedy.

Mr. KENNEDY. I think I will pass right at the moment, Steve. Thank you.

Chairman NEAL. OK. Mr. LaRocco. Mr. Orton.

Mr. ORTON. No questions.

Chairman NEAL. OK. Mr. Barrett.

Mr. BARRETT. Thank you, Mr. Chairman.

Mr. Hove, I would like to go back to the Wisconsin situation. You said that Wisconsin is somewhat different. Have you found that the conversions in Wisconsin have, with respect to the 25-percent rule, have they fallen within that guideline for insiders?

Mr. HOVE. I haven't looked carefully enough at the individual conversions in Wisconsin to speak to that, but I would be glad to get back to you and find out.

[The information referred to can be found in the appendix.]

Mr. BARRETT. When you said Wisconsin was different, what were you referring to?

Mr. HOVE. The differences between Wisconsin and the OTS and the other States are listed and laid out in my testimony.

Mr. BARRETT. Mr. Fiechter, you mentioned that you felt there was a more potential problem for merger conversions than bank conversions—than a straight mutual to savings conversion.

What do you think we should be doing to address that problem?

Mr. FIECHTER. Holding hearings. Within OTS, we have actually wondered if we shouldn't, for healthy institutions—I would like to, and I think all of our commentary has pretty much excluded undercapitalized institutions where the objective is to buy them, and if capital can come in, we all benefit. But for healthy institutions, we have wondered if we shouldn't ourselves really slow down, if not declare a moratorium on merger conversions.

If an institution wishes to sell itself to another thrift or bank through a stock acquisition, there is a tremendous benefit, I think, to the depositors of that mutual to first convert to a stock organization, and then let the acquirer buy the institution in the stock market the way any other institution is acquired. The concern that I have with a merger conversion is not infrequently you may have a lot of account holders at that mutual who are offered stock in an-

other bank or thrift that they know nothing about. Frequently they are offered the opportunity to buy the bank at a market price, and they are not given any of the true net worth in the institution that is converting. So I think from the standpoint of depositors, there is really a significant disincentive to having an institution go the merger conversion route.

Much of our regulation is designed to make certain that the depositor gets their fair share of the net worth of the institution that converts. That is very difficult for us to achieve in a merger conversion the way the process now works.

Mr. BARRETT. I agree with that, but I also look at the conversion from a straight mutual to a straight stock, and I think this may go to some of the comments Mr. Hove had. By and large, if I could categorize people who put their money in savings banks, I would assume that many of them are conservative in their investments, and so they are not the type of person that is going to go out and borrow $1.5 million to purchase stock if there is a conversion.

It just, for a 70-year-old woman who has had her money in a savings bank her whole life, if someone came into her and said you can get rich, honest, you can get rich, just go borrow this $1.5 million and you will be able to flip $750,000 in 1 day, first of all, she wouldn't believe you, and second, it is beyond the realm of her life to do that.

It seems to me that when you discuss this issue with ordinary people, what you are telling them is somebody is going to get rich on these conversions. The question is who? And it seems to be that it is set up for insiders and it is set up for flippers who can deposit money in different accounts throughout the country, assuming that there is going to be a conversion.

But the person who is certainly left out is the person who doesn't want to purchase stock, yet they are the person who owns the mutual savings bank. Should we be looking at an entirely different approach where the money does go to the people who actually own it, even if they are risk adverse to purchasing stock?

Mr. FIECHTER. I agree. I think the OTS rules, in a sense, go halfway, in that at least under our rules the depositors are given the first crack at the stock, ahead of the insiders. But I agree with you. I am not certain my parents, if they were given an opportunity at their age to convert, in essence, their deposits to stock in a new institution, would take advantage of it, regardless of how attractive the broker told them that stock would be.

Mr. HOVE. Could I come back to you, Mr. Barrett, because I think in the Wisconsin area it is a question of rules versus actual practice. Because we have not found cases where the practice in Wisconsin is significantly different from other areas. The rules are different, but I think the practice is not significantly different than other States.

Mr. BARRETT. That was my understanding, that the regulations were looser, but that the practice of the commission has been to stay roughly—although I have a memo here, and I will ask Mr. Lee when he is here, that says that one recent transaction allowed saving bank management employees to purchase approximately 72 percent of the stock sold by the institution. I frankly don't know

which one they are referring to there, so I will be asking Mr. Lee that. But I think my time is up, so thank you very much.

Chairman NEAL. Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman. You asked a good question earlier, why don't we just adopt the OTS rules? But in the very well-publicized Green Point Bank of the attempted takeover or merger by Republic Bank, it was reported—and I am glad that Superintendent Cephas acted forcefully to protect the interests of the depositors of Green Point, but my question is, the information reported in the press stated that the officers and directors would have received $140 million in this particular case, and I believe they said that no one would have received less than $1 million. And this was the officers and directors of the bank.

Yet this purchase, as I read, was under the guidelines of OTS, which had a 15 percent cap on how much a director could receive. How did it get so high? How did they reach $140 million amount, which Cephas ruled was excessive, under the OTS rules?

Can you in a general sense familiarize us from this example of how it got to such an exorbitant amount of money, just for having been in the right place at the right time?

Mr. FIECHTER. I can do that for the record. That was not an institution that we supervise. It is not an OTS-supervised institution.

Mrs. MALONEY. But it stated in the press that they followed OTS procedures and guidelines.

Mr. FIECHTER. That sounds as though—the $140 million does not sound consistent with what we would have permitted under our regulations. But I would have to—I haven't studied their prospectus, and so I can't comment. It may be that through stock options and a number of areas of compensation that the management and officers could earn over the next few years, it may have gotten that high, but it sounds very high. Our 15 percent rule applies more to merger conversions, and the rules are that management cannot get an increase in their compensation that exceeds the greater of $10,000, or 15 percent increase in their salaries.

Chairman NEAL. Will the gentlelady yield?

Mr. FIECHTER. It just doesn't come close to that kind of limit.

Mrs. MALONEY. Yes, Mr. Chairman.

Chairman NEAL. Let me just ask a followup question on that.

Do you include all compensation, or just direct compensation?

In other words, could there be a side deal with a stock option or something like that that vastly exceeds the 15 percent rule?

Mr. FIECHTER. The stock options where they earn it over time, they could have stock options that——

Chairman NEAL. Or stock bonus, or something that would be paid out over the next 10 years, and deferred compensation and other things? In other words, your rules don't cover all of that?

Mr. FIECHTER. They do not—the 15 percent does not cover that directly, no. We do permit stock options. We have——

Chairman NEAL. That may explain part of this.

Mrs. MALONEY. I think that is an excellent question, Mr. Chairman, and what I feel would be helpful is if you took the Green Point case, which the documents that I read said that they adhered to the OTS guidelines, and let us see how they were able to run the numbers up so high. I believe everyone—just common sense

dictates it was excessive, and as we look at changing regulations, which Chairman Gonzalez has had a bill in for a long time, and I commend Chairman Neal for moving forward on it, it would be helpful for us to see how that happened and how we should regulate in a way that depositors are more protected.

Mr. FIECHTER. I am told by one of the OTS employees that we have never received an application that envisioned that type of compensation, so that——

Mrs. MALONEY. The point is not whether you received it or not; the point is that they have announced that they followed your guidelines, and if they did not, I would like—do you see what I am saying?

Could you look at it and let us know? Because they are saying through these loopholes when the chairman pointed out they were able to run up excessive amounts, and I think we should be aware of it. And sometimes I think thinking broadly, as an example, is a way to approach it.

Thank you.

Thank you, Mr. Chairman. My time is up. The red light is on.

Chairman NEAL. Thank you. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

Mr. Fiechter, the issue is a little complicated in the sense that if a conversion is going on, you also sometimes have mergers in the same instance; is that correct?

Mr. FIECHTER. Yes. There is something called a merger conversion which includes a simultaneous merger conversion from mutual stock as part of a merger by an institution.

Mr. VENTO. The point is you then have to combine and look at salaries in a different vein; is that correct?

Mr. FIECHTER. Yes.

Mr. VENTO. Can you give the subcommittee an idea of what the notice to depositors would be like in that instance. In fact, would it be determined that there has actually been a vote by the depositor, as required under OTS guidelines?

Mr. FIECHTER. Under OTS guidelines, the terms of the transaction, including any type of compensation received by the management of the thrift, have to be disclosed to the depositors, who then have to vote on whether or not they agree with the deal going forward.

Mr. VENTO. At least half of the depositors have to agree, is that correct? Is that based on an individual depositor or is it based on the amount of assets that they have in an institution?

Mr. FIECHTER. The majority of the depositors have to approve—the majority of the account holders have to agree with the conversion. Included in that, I should say, however——

Mr. VENTO. And it is a description of compensation to officers and directors and so forth, as you pointed out?

Mr. FIECHTER. Well, for direct compensation for managers and directors, we do have a limit of managing directors' compensation in the merger conversion. It cannot exceed $10,000 or a 15 percent increase in their compensation, whichever is lower.

Mr. VENTO. How confident are you that given the stock options and other aspects of retirement benefits and so forth that that is really upheld? Are you pretty confident about it?

Mr. FIECHTER. I think in terms of direct compensation, I am pretty comfortable that the compensation stays within that limit. Over time, however, management can gain stock options if they stay with the newly acquired institutions, which can clearly exceed that.

Mr. VENTO. I guess it is a question of how far back you reach and how far forward you monitor, too, isn't it? I mean I don't want you to understate the potential here for changing or modifying compensation. You, as a rule, do not when you look at compensation, but you don't principally set compensation and limitations; is that correct?

Mr. FIECHTER. No, I don't think it is. We have been criticized, and a reason that thrifts have given for converting to a State before they merge was our rules on compensation were too tough, and they feel they are unfair. That if you are management of a mutual, you have been there for years, and it is because of you that it is worth so much money, they believe that our rules are too tough, and if they convert to a State institution, recently, not infrequently their compensation can be greater. And they think that they deserved that. I think it was referred to in the hearings in North Carolina that we were being paternalistic in seeing what the management got.

Mr. VENTO. My point is in looking at compensation, while the OTS looks at compensation in terms of the institution's safety, soundness, its regulatory responsibilities, and the same for the FDIC, I don't know that any of you think of yourselves as principally regulating salaries as a major role.

Mr. FIECHTER. It is major, but FIRREA and FDICIA put regulations on us.

Mr. VENTO. It is a question, Mr. Hove, of how that translates in terms of these conversions. I mean these new responsibilities, which I very much agree with, but obviously are not as finely defined as they could be. They are issues, really, that have to be brought to this particular issue in terms of this conversion from mutual-to-stock at the State level I guess through the bank, this bank organization, wouldn't you say?

Mr. HOVE. I would agree. In fact, let me speak to Representative Maloney's comment about Green Point.

First of all, the $140 million, I think, was an appraisal value after there had been substantial stock appreciation. But even if you take $140 million, that is within the 25 percent compensation guideline of the OTS. That it is an issue that is very important. The important thing to understand is that a small percentage of a large institution still is a very large number.

So that the Green Point compensation plan would in fact be within the standards of the OTS.

Mr. VENTO. Mr. Chairman, I see my light is on, too. We owe Acting Chairman Hove and Director Fiechter a debt of thanks for their work during this interim period. Congratulations to Mr. Hove on being reappointed. We look forward to continuing to work with them.

But what belies us is the supposition that S&Ls are not profitable, and here we have a situation with the market in terms of the conversions that we are talking about are saying something quite

different. It sounds like there is a big increase in terms of stock by virtue of some of the mergers and so forth.

And, as you said, 25 percent of $140 million, that represents a significant profitability. I guess the concerns that we would have is whether or not those institutions and the type of speculative activity that takes place with the stock doesn't result in a windfall, but more importantly, we are certain as to the safety and soundness of the institutions and that they are adequately capitalized. From the experience, the most recent experience that we have had, there are a lot more questions on this issue, but it is clear to me that at the very least the guidelines of the OTS need to be brought to bear at the State level as a frame of reference, if nothing else.

Thank you, Mr. Chairman.

Chairman NEAL. Yes, sir. Thank you.

Mr. Kennedy.

Mr. KENNEDY. Thank you, Mr. Chairman.

I wanted to really just ask Chairman Hove a question. I understand the—I think the rationale, while a lot of these banks have done very well, it seems to me that underlying, underpinning a lot of that has obviously been the fact that you provide insurance and that that gives investors a very sound kind of foundation to then get a spring-up in terms of what the new increased value of some of these stock values might be.

Now, at this point it all seems to make sense because the value of these institutions has gone up. But I also was on this subcommittee when the values of those institutions wasn't so high, and when we had to pay a hell of a lot of money to your shop in order to deal with some of the problems that the banks have faced.

So I wonder whether or not there isn't some kind of principle that we ought not to be looking at that indicates that there ought to be some value that is either paid back to the FDIC when these stock runups take place in order to deal with some of the shortfall that the taxpayers had to shore up over the course of the last few years, number one; or number two, if that isn't in place, and maybe Mr. Fiechter has some ideas on this as well, whether or not there ought not to be some kind of community fund or CRA commitment that is borne by these very large runups in prices.

I mean it seems to me from the questions that Mr. Barrett and Carolyn Maloney, as well as the chairman had asked, what you have is a situation where despite the fact that the ownership is held at the local level, what you really have is a few officers and a few directors of these institutions that are enjoying these fantastic runups, despite the fact that it really has been the U.S. taxpayer and the local community that have borne the risk, and in many cases are the basic fundamental reason why the prices have gone up. And yet when it comes to cashing in, they get very little benefit. So there is sort of this injustice that is taking place. You are the regulators, so you are trying to make sure that that doesn't exist.

Do you have some ideas on what we could do to deal with these inequities?

Mr. HOVE. You know, it is an interesting concept, and I think you are exactly right. At the time that we were having difficulties, and there wasn't a value in these institutions. It certainly was to

our benefit and the taxpayers' benefit and the community's benefit to have these conversions take place so that the stock came in, money came in, and capital came into the institutions. In fact, the institutions become healthy so that they did not become a cost. There is no question about it.

What has made all of this issue come about is the tremendous growth that we have seen in the value of these institutions. We have seen it in the industry nationwide. We have seen a real runup.

It used to be that stocks in financial institutions were selling at 60 to 80 percent of book value. We are now seeing them at 2 and 2.5 times book value. There has been a great increase.

That is what caused this intangible value that everybody is looking at. You are exactly right, that maybe some of this belongs to somebody other than depositors or insiders. It is an interesting concept that is worth looking at.

I might also mention that some of the institutions that have converted have, in fact, placed some of their money back into their community. This is precisely what you are talking about.

Mr. KENNEDY. Apparently, to try to buy off the depositor who wasn't getting anything out of the deal, right?

Mr. HOVE. Well, I am not sure what their motivation was, but they did put money back into the community in a very noble and worthwhile project.

Mr. KENNEDY. All right. Sounds like they are great Americans. Mr. Fiechter.

Mr. FIECHTER. I think we ought to move pretty cautiously. I have some sympathy with what you are saying. I think one difficulty is that the institutions that cost us all so much money are not the institutions that we are talking about. These are institutions that actually ran their shops pretty cleanly, and there is an ongoing debate within the thrift industry as to how much are the thrifts that didn't get into trouble responsible for paying for the sins of those that did.

I would echo Skip's comments, and I think, Mr. Kennedy, actually, there were some noble thrifts out there. We had a thrift, Quaker City in California, that as part of their prospectus in raising capital as they converted from mutual to stock, put I think it was $6 million aside to set up a community development bank solely to return some of that net worth back to the community. And I think it is really the community that does deserve in some form or another a crack at some of this net worth.

Mr. KENNEDY. Well, I appreciate your comments. I don't think that this has to be viewed as a penalty payment. It seems to me that what we are really talking about is the fact that underneath the essential runup that has taken place has been this commitment that has been borne essentially on the shoulders of the ratepayer—excuse me, the taxpayer and the depositor. They are the people that are being left out of the benefit stream.

So all that I am trying to suggest, you don't have to go—characterize this as a penalty payment for past sins of other failed institutions, but rather the fact that there have been—there is a system that works; the system that works has created benefits, those bene-

fits ought to be empowering more than just an elite core of directors and insiders in the institutions.

Now, you say, well, that is a good idea and we ought to think about it. I guess I would like to maybe hear a couple of ideas or proposals from you so that it isn't just sort of an antagonistic relationship between, you know, some people on the House Banking Committee and the regulators in terms of us trying to find out and push you into doing this.

But it seems to me that this is entirely reasonable for us to expect the regulators to establish some kind of framework where these runups take place, that target amounts ought to be set aside for—I don't know, you know, they could support President Clinton's new community development bank, they could support local CRA efforts in the local community, they could support housing or small business or economic development at the local community.

But I certainly just don't think we ought to be sort of saying, well, we will allow this to take place; yes, there is some benefit that should go to the local community and we will study it, and then Skip, you know what I am talking about, by the time we finish studying the problem, the runups will have occurred and there won't be any money left.

So if you are going to do it, you got to sort of, you got to grab it while the monkey is still in the cage, you know?

Mr. FIECHTER. I accept that. I think you are right. We had some 2,000 mutuals; we are down to 800. So if we study this another 2 years there won't be any mutuals left.

Mr. KENNEDY. Right. Can we get—I don't know, Mr. Chairman, this sort of works off of an idea that you were kind of espousing a little earlier. If there is some way that we could ask both Mr. Fiechter and Chairman Hove to give us maybe a range of two or three different concepts as to how these deals could be structured at the local level that would enable local benefits to be established? Would that be a reasonable way to proceed?

Chairman NEAL. Sure.

Mr. FIECHTER. We would be happy to do that.

Chairman NEAL. We would certainly welcome your views.

Mr. KENNEDY. Thank you very much.

Thank you, Mr. Chairman.

Chairman NEAL. Are there any other members who would like to question or comment? OK.

Gentlemen, thank you all very much for your help. I have some more questions and maybe others do that I would like to submit for the record. We will be in touch with you. Thank you again, we welcome your ideas as we move forward on this. Thank you again for your help this morning.

[The information referred to can be found in the appendix.]

Chairman NEAL. Our next panel consists of Harold N. Lee, savings and loan commissioner, State of Wisconsin; and William Drumm, superintendent, Division of Savings and Loan Associations and Division of Savings Banks, State of Ohio.

I would like to recognize Ms. Pryce at this time who I believe would like to say a word or two about Mr. Drumm.

Ms. PRYCE. I am going to have to leave, unfortunately, and I just wanted to take the opportunity to welcome my colleague from Co-

lumbus, Ohio, Superintendent Drumm here from Columbus and welcome his testimony for the benefit of this entire subcommittee on the issue.

Thank you very much. Thank you for your travels and being with us today.

Chairman NEAL. Thank you, ma'am. Mr. Barrett.

Mr. BARRETT. Thank you, Mr. Chairman. It is my honor to introduce Mr. Lee to the subcommittee. Mr. Lee has been in the Commissioner's Office for 26 years in the State of Wisconsin and I am proud to say that the State of Wisconsin has had an excellent record in the area of thrift supervision throughout the entire last 25 years.

Chairman NEAL. Thank you, sir, very much.

Gentlemen, thank you very much for being with us this morning. We will put your entire statements in the record and ask that you summarize so we can have a little more time for questions and answers. If it is all right with you, we will hear from you in the order in which we mentioned your names originally.

Mr. Lee, we will go ahead and hear from you then.

STATEMENT OF HAROLD N. LEE, SAVINGS AND LOAN COMMISSIONER, STATE OF WISCONSIN

Mr. LEE. Thank you, Mr. Chairman, subcommittee members. As Mr. Barrett indicated, I am Harold Lee, Wisconsin Savings and Loan Commissioner. I have been at that office for 26 years.

Wisconsin's record speaks for itself. We have experienced only one State-chartered failure. The average tangible capital of our State-chartered system exceeds 12 percent to assets and we have no serious problems.

In Wisconsin we have had 24 conversions from savings and loans to savings banks. Of those, only two were previously federally chartered institutions; three were mutual institutions that have now converted to the stock form, and I anticipate a few more.

But the majority of those institutions continue to operate as mutual institutions. Savings and loan associations continue to move to the savings bank structure to escape the cost and the frustration of the second regulator at the Federal level, not to get a fat deal from the State regulator in a mutual-to-stock conversion. To give you a little background, we need only go back to 1980 and the first mutual-to-stock conversions in Wisconsin. There have only been a handful since that time, except for the past 2 years.

In 1991 and 1992, we have had 14 mutual-to-stock conversions at both the State and the Federal level; 11 of those under OTS policy, three under the State policy, which while not exactly the same as Federal policy, it is fairly close.

The most infamous, of course, is the Security Bank, SSB transaction in Milwaukee, which has engendered an awful lot of press recognition.

Public offering was $270 million. Under State jurisdiction, 7 percent of the public offering went to the employee stock option plan, the ESOP, 5 percent for a management recognition plan, the MRP, although only 3.6 percent of that MRP was awarded. A 3 percent management set-aside was established to assure management of a reasonable purchase level. Management purchases totaled 7 per-

cent of the total offering after the allocation reductions at the depositor level.

Benefits in this transaction are within the policies of OTS as demonstrated by the Astoria Federal conversion in New York with an ESOP of 9.9 percent and an MRP of 5 percent.

Security Bank is a "1" rated institution in safety and soundness and compliance. They have also received a CRA rating of outstanding. This is one of the finest thrift institutions in the Nation.

Would it be fair to this institution for me as a State regulator to provide less benefits than provided under OTS policy just because they are a State-chartered institution?

Think about that for a minute.

In Wisconsin, the terms of all conversions to savings banks are controlled by my office on an individual basis, and provide insider benefits very similar to the policy limits of OTS. We have, however, encouraged the use of a management set-aside as a part of the transaction. Setting aside a small portion of the offering to ensure that management has the opportunity to purchase a reasonable amount of stock is very realistic from a regulatory perspective.

If the management group have their own funds at risk, they will be more prudent in their management responsibilities. Also consider that all management purchases during conversion must be held for at least 1 year. How many stock offerings do you think would be sold out if all of the purchasers had to keep their stock for that full year? I don't believe there would be any.

As you can see from all of this, it is not the State systems that are the problem, it is the implementation of policies developed under the Federal system, especially when applied to large offerings. In Wisconsin we have experimented with the use of Federal policies in our first three conversions and have already started to make some adjustments, but that is difficult when an institution can switch to a Federal charter and convert under OTS policy. We have had four conversions from State to Federal charter in the last 2 years.

It is time to take a good look at benefit policies and make some changes. Current OTS policies worked well for several years, but under current market conditions may be too lucrative, especially for very large transactions. It would make sense for the FDIC to adopt guidelines covering all mutual-to-stock conversions in the thrift industry. They will need the authority to step in whenever a State or Federal regulator allows benefits significantly outside of their guidelines.

This will do away with most of the competition between the State and Federal agencies, and allows for some innovation and flexibility in the system. We as State regulators would be more than happy to work with the FDIC in developing reasonable guidelines that protect State's rights and still provide the Congress with the comfort they are looking for.

As I see it, H.R. 3615, as proposed, is an irresponsible attempt to override State's rights and impose rules on the Nation that don't work. I believe it has been promoted by OTS and it is apparent to me that there has been no input from the State regulators up to this point or from their national organization.

H.R. 3615 is a step backward for the dual system. We all know that the innovation in financial services comes from the State system. If you shut the door on the innovation and eventually federalize the regulation of financial services providers, you will seriously damage our banking system in America.

Thank you.

[The prepared statement of Mr. Lee can be found in the appendix.]

Chairman NEAL. Thank you, sir, very much.

Mr. Drumm.

STATEMENT OF WILLIAM DRUMM, SUPERINTENDENT, DIVISION OF SAVINGS AND LOAN ASSOCIATIONS AND DIVISION OF SAVINGS BANKS, STATE OF OHIO

Mr. DRUMM. Thank you, Mr. Chairman, and members of the subcommittee.

Most of the position that I would like to relate to you today is already in the prepared statement that you have before you. Just a few additional comments that I would like to make, more for emphasis than change. I would like to say at the outset, I had not heard or seen Mr. Lee's comments prior to just now, but I do have to concur with the position that he has taken on the part of Wisconsin.

As I point out in the testimony, Ohio, too, has a rather sterling record in the performance of the associations, the thrifts in Ohio. We have 104, 105 such institutions that come under the regulation of the office of which I am superintendent.

I would like to say that the attitude of the majority—and I have done an informal poll around the State of Ohio among managing officers. But the sense that I get from those that are mutuals and have any thought at all of converting to stock is not—they are not motivated so much by the opportunity for self-enrichment as they are with concern for the ongoing health of their institution.

Ohio's institutions are what I would call the medium- to small-sized community S&Ls and savings banks. So you are not talking about great dollar amounts in each of the individual cases. What they are concerned with is that they have the opportunity to reach the capital markets while that window is still open.

It was mentioned earlier by one of the gentlemen that if you look back only as far as 1983 or 1984, and the market conditions that prevailed then in stocks, you would just about have to point a gun at someone to encourage them to buy a share of S&L or savings bank stock. Those conditions we hope were temporary and had only one lifetime. We hope that we have outlived that terrible period.

However, as we all know, the stock market comes and goes. The window is terrific right now, and I think a lot of our judgment may be tempered by the fact that we are in that temporarily ideal kind of a situation. My concern is, what happens when that romance with the thrift stock begins to cool?

I would hate for anything that we do, either in the State or the Federal level, would deter in any way the opportunity to get into the capital markets by those who wish to.

For the mutual, the only way that they can maintain a net worth position is through their earnings. That is no big secret. They have

no way of raising capital in any other fashion. So it is important that they provide for flexibility by getting away from the mutual concept and gaining the ability to reach into the capital markets.

Another point too, and this is a little bit of a departure of that line of thought, but it occurs to me that what we are talking about is and has been referred to as the "new" savings banks. True, in about a half of those (there were eight such States) the chartering process is new, the statutes are new. But savings banks themselves are not new.

Those of you who are familiar with the eastern part of the United States, there were about 16 such States that have had savings banks for generations. They are not under the purview of OTS; they are under FDIC and the State regulators. My point is that although we think of them as being new, they aren't so new after all, because those statutes pretty well parallel the statutes that the original States, 16 States have had.

That pretty well sums up what I had wanted to add.

[The prepared statement of Mr. Drumm can be found in the appendix.]

Chairman NEAL. Thank you very much.

Mr. Lee, you said you thought it would make sense for the FDIC to adopt guidelines. Why not OTS?

Mr. LEE. As a State regulator, I feel it is probably improper for the State system to be regulated in any way by a federally chartered agency. I believe that the insurance agency has the authority to oversee the State system and has done that very well. I don't believe that there is any necessity in any system that I know of to have a State regulatory—or a Federal regulatory body—overseeing the State regulatory system on top of the FDIC.

Chairman NEAL. OK. What about on the matter of the substance of what should be done? You were critical of the bill, but I think you were critical of it on the basis of State's rights in this area.

Mr. LEE. Yes.

Chairman NEAL. In terms of what the bill would accomplish in placing limits on the benefits to so-called insiders, if that were done by the FDIC, would you find that reasonable?

Is that an approach that makes sense to you or not?

Mr. LEE. Yes. I think that what we need is a different system of establishing the benefit packages, if there is going to be benefit packages, in the conversion process. Using the current system of a percentage of conversion proceeds has proven operable in a market like we are dealing with today.

I think we have to find a new system. And I suggest the FDIC be responsible for that oversight, because I think as the insuring agency, they should be looking over all of the transactions, not just one part of the system.

Chairman NEAL. OTS does regulate State savings and loans.

Mr. LEE. OTS does have authority over State-chartered savings and loan associations under FIRREA as the primary Federal regulator.

Chairman NEAL. But you don't like it? I mean that is your point, right?

Mr. LEE. That is the major reason for the switch from savings and loans to savings banks.

Chairman NEAL. Right. I understand that.

Well, it is certainly one of the reasons. Anyway, you say that the rules—the OTS rules, regardless of the State/Federal relationship, I am just trying to get down to substance, don't work in today's market and the FDIC ought to develop something else. Do you have any idea what that should be yet, or would you want to give that a little thought and give us some advice on it? It would help us certainly if you would do that.

Mr. LEE. Certainly. I will be giving some material to the subcommittee and I will also be presenting some material to the FDIC on their proposal. They have open comment.

Chairman NEAL. Yes, they do. Let us have a copy of that, too.

Mr. LEE. Absolutely.

Chairman NEAL. Now, it does strike me that the OTS certainly is not perfect—their rules and regulations are not perfect either. You know, this just wouldn't—we just wouldn't be dealing with this if it weren't for the high compensation.

I mean it just wouldn't be on anyone's radar screen, I don't think. Because clearly to me, anyway, I hope I am right on this, I will be glad to hear if someone disagrees and I wish they would tell me, but there are clear benefits to everyone, it seems to me, from the conversion from mutual to stock.

Institutions end up better capitalized, healthier, and so on; depositors, if they want to, can participate in that conversion usually, and there is more flexibility, and the taxpayers ultimately, I think, benefit if the institutions are stronger. So I don't see myself any problem with that; it is just that what doesn't look quite right are these big compensation packages. That is what has attracted our attention to this.

Mr. LEE. Absolutely. As I pondered the approval of Security Bank in Milwaukee, the Astoria Federal transaction sat on my desk, and I think that is why we need somebody outside of the State/Federal system of chartering to handle the oversight of conversion process, so it makes more sense, it sets up so much, but still allows the Federal agencies and the State agencies to have some flexibility within the system so that they can treat institutions differently depending on how well they have run their institutions, their capital position, those kinds of things.

Chairman NEAL. There was also the situations in merger conversions where it doesn't appear that the depositors have had an adequate chance to share in the benefits. So that I mean there is a sense of unfairness in this whole process that——

Mr. LEE. Particularly in the merger conversions.

Chairman NEAL. Exactly, exactly.

Mr. LEE. That just needs to establish some way to control the insider benefits and to make sure that the depositor of that acquired institution can buy stock in the acquiring institution at a much bigger discount than is typically allowed.

Chairman NEAL. Now, wasn't there a conversion in Wisconsin involving the Guaranty Bank that offered insiders 65 percent of the conversion stock?

Mr. LEE. Yes, there was. That was a mutual holding company transaction, and left the other 47 percent of the value of the institution that was sold, 53 percent of that institution remains with

the depositors under the mutual holding company. While the insiders—and this is "insiders" by somebody else's definition, it doesn't fit within the definitions of OTS or my office.

Management bought—meaning the top management people board of directors bought about 32 percent of the offering. The management of the mortgage banking subsidiary bought another 20 percent of the offering. Then there was a small employee stock option plan; there was a 4 percent MRP, and there was a portion of a 35 percent reserve for the depositor that was keyed to going to the employees who got nothing else.

In the end, even concluding the employee stock option plan in the numbers, the insiders own only 32, 33 percent of the institution. If this ever goes to market, they have already gotten their share and there is nothing left. The reason for this transaction in the first place was that it is a very unique institution.

It is about $375 million in assets, and it has a mortgage banking portfolio of about $4 billion. It has offices all over the country, including major operations in California. The risk in this institution is significantly different than in a typical savings and loan operation.

Chairman NEAL. Mr. Barrett.

Mr. BARRETT. Thank you, Mr. Chairman. I think, Mr. Drumm, you pointed out correctly that there is a window of opportunity here to capitalize these institutions. The concern that I think many of us have is who the window is open to. And I look at the Federal rules and I look at the State rules and I don't see account holders having any priority. Why don't we give priority to account holders?

Mr. DRUMM. I can speak only for Ohio right at this moment, and I will preface my answer by saying that, Mr. Barrett, the staff and myself have finished just Friday afternoon, late, a complete revision of our rules governing conversions from mutual to thrift, and included in that is a substantial amount of space devoted to acquisitions. They are not—they will be in final form this coming Friday and will be prepared to go out for hearing.

In answer to your question, in those new rules, the first option for the purchase or subscription to stock goes to the shareholders. The complete cycle of that offering is completed first. Then the other priorities kick in, in their related degree of importance.

So we feel that we have built in all of the protection that could be if through an adequate program or requirement, I should say, of informing the depositor what the proposal is, would require a board of directors to circulate the disclosure to every depositor. We do not permit ongoing, continuing proxy use in voting on such issues as this.

Mr. BARRETT. Issues as what? I am sorry.

Mr. DRUMM. Conversion.

Mr. BARRETT. So proxies are not permitted in the conversion process?

Mr. DRUMM. Converting from mutual to stock, we don't permit the use of continuing proxies. They must solicit new proxies for that purpose. The reasoning behind that is rather obvious. We want to make sure that those depositors know what is going on.

Mr. BARRETT. I understand.

Mr. DRUMM. We have also put in a majority requirement of 60 percent vote in favor of the issue. We think those two items themselves will go a long way to protecting the depositors and whatever rights they may have.

Mr. BARRETT. So you will have an account holder preference and a majority vote.

Mr. DRUMM. Yes.

Mr. BARRETT. Mr. Lee, in Wisconsin my understanding is we don't have either of those.

Mr. LEE. We don't have the depositors where they are a first priority. First priority is the employee stock option plan, as it is with the Federal level.

The second priority goes to management and the management set-aside, and then the majority of the stock goes to the depositors as the next priority. So there is a priority and it does include probably 80 percent of the offering.

Mr. BARRETT. But if the Wisconsin rules permit up to 35 percent to go to management, does that include the ESOP as well?

Mr. LEE. No.

Mr. BARRETT. What is the maximum for the ESOP in Wisconsin?

Mr. LEE. Ten percent.

Mr. BARRETT. So 45 percent. So it sounds to me rather than 80 percent under the Wisconsin law, the account holder could be faced with 55 percent.

Mr. LEE. Yes, they could. But in actual practice, that is not the case. The reason we left the 35 percent in there is to allow for that kind of purchase in the kind of era that we just passed, where it was very difficult for an offering to get sold. We need to have that authority out there in case we want to use it. We don't anticipate anybody going near that level.

Mr. BARRETT. The Eau Claire transaction that just fell through, what type was that?

Mr. LEE. That was a merger conversion. They have now announced a full regular stand-alone conversion.

Mr. BARRETT. And the mutual conversion that is being discussed is what type of conversion?

Mr. LEE. A mutual holding company conversion.

Chairman NEAL. Will the gentleman yield briefly?

Mr. BARRETT. Yes.

Chairman NEAL. I am told that in the transaction proposed by the Mutual Savings Bank that no stock would be sold to the depositor?

Mr. LEE. That is in the proposal, but at this point the application is not complete and I have not taken the time to go over it in detail. Action will start on that after the application is complete.

Chairman NEAL. Was that something that you would allow?

Mr. LEE. Not very likely. But I don't know what the transaction says until I get a chance to go through it.

Mr. BARRETT. How, under Wisconsin law, is it permissible if you are saying that a majority of the stock remaining after the ESOP and the management purchasers is to the account holders, how would it ever be possible to have a conversion that completely shuts out the depositor?

Mr. LEE. In a mutual holding company, a private placement is possible, and that is what this is considered. We have never done anything like this. The other mutual holding company was Guaranty and that was a public offering along with what we did inside. This is a proposal that is on my desk.

I heard about it on the street and from the press before I saw it. And it doesn't—to me, it doesn't make sense for me to take my time to review that process until I have the entire application in front of me and can make a reasonable judgment.

Mr. BARRETT. OK. I don't have any further questions, Mr. Chairman.

I am sorry, let me ask one question. Because as I was going through the Guaranty prospectus this morning, one of the things that jumped out at me was the ability that the bank reserves the right in its own discretion to accept or reject in whole or in part any and all orders in the offering or as soon as practicable following the receipt of the offering.

Is that something that is standard? It jumped out at me saying that the insiders could decide who could buy the stock.

Mr. LEE. It is not standard; it is not typical. This was the first method we used to keep the stock within—keep the purchasers of stock within Wisconsin. We have taken other methods now with geographical limitations so that the institutions going public can make sure that their stock is purchased by the citizens of Wisconsin and not from the flippers from all over the country.

Mr. BARRETT. But would you permit this phrasing in an offering today?

Mr. LEE. No longer, no.

Mr. BARRETT. Is that part of Wisconsin law?

Mr. LEE. No, it is not in the law anywhere.

Mr. BARRETT. OK. Thank you.

Mr. LEE. The law is fairly broad and leaves an awful lot to my discretion.

Chairman NEAL. In addition, though, in that case, the management had the right to disapprove stock purchasers based on the depositors' financial status and ability to undertake the investment risk, I understand. Is that correct? In making a judgment they could say, just look at someone and say, well, we don't think you can take in risk so we won't let you get any stock?

Is that the way it works?

Mr. LEE. That was the language that was in there. This was our first time through a transaction like this as the primary regulator, and while the language was there, it is not put into practice in that transaction. It will not be in any other transactions going forward.

Chairman NEAL. That is not something that you would repeat, then?

Mr. LEE. No, sir.

Chairman NEAL. Mr. Vento.

Mr. VENTO. Well, thank you, Mr. Chairman.

Mr. Drumm, in your prepared testimony, you point out that these conversions which are going on, especially from a mutual to stock straight, are in fact necessary to meet capital standards that were imposed in 1989 and in subsequent years, and have been im-

posed for the institutions, so that they can go into the private market and basically raise money through a stock option?

Mr. DRUMM. Yes, that is true.

Mr. VENTO. But there is a lot of other activity going on here in terms of mergers and geographic presence, too; isn't there?

Mr. DRUMM. We have not had any significant activity in mergers or acquisitions. Only one in 1993, as a matter of fact. What I was referring to earlier was statements that I am getting from managers of existing mutuals and their plans to move from mutual to stock. Several of these are of significant net worth; 12 to 16 percent. And their original concern was that they could generate too much net worth and they would have no place to put it.

So what they are trying to do is carefully time the offering. Also, the goal is to establish some flexibility when there is a downturn a few years hence, if such would happen, that they can raise capital.

Mr. VENTO. Well, I understand that FIRREA or other laws may have been a motivation, but there also is an active group working, a Cincinnati bank they point out in the body of the story here that I am reading, Provident Bank Corps., which has been offering to give savings and loan executives in Ohio, Indiana, and Kentucky 15 percent of their thrift's value if they go through with a merger, that they are actually portraying that as what the benefit could be, I guess, in this particular activity. You are obviously aware of this.

Mr. DRUMM. Yes, very much so.

Mr. VENTO. That is the genesis for your changing the rules; is that correct?

Mr. DRUMM. Yes, yes. We didn't feel that we had rules that were adequate to cover all of the eventualities of today's practice, as a matter of fact, or attempted practice. Regarding Provident, to date we have had only one application for their acquisition of an institution, and it, by the way, was maintained when it was acquired, it was maintained as a savings bank, and their intent is to keep it as such for at least 5 years. There are certain advantages in community service that go along with that.

Mr. VENTO. But this isn't obviously a capital option then, is it? I mean this particular pattern here wasn't for capital purposes.

Mr. DRUMM. No, no, this is a small company. What really started their move toward the acquisition by Provident was the fact that they had an aging management team and board of directors that chose to go this way rather than try to regenerate terms through new appointments.

Mr. VENTO. It looks to me, based on the testimony, did you say you had 104 institutions?

Mr. DRUMM. Yes.

Mr. VENTO. So you are really only in the early stages of what, if this were to be repeated, you have a lot of raw material there to work with in terms of conversions, is that correct?

Mr. DRUMM. The stories have been in the rumor form around the State for quite a few months now. I understand that a number of banks have people almost full-time out on the road trying to buy institutions.

Mr. VENTO. Well, yes, that is why I raised it. You know, you said this was the noble purpose of building capital, that I wanted to

look at what—if there were some other noble purposes going on here, or ignoble purposes in terms of acquisition. Mr. Lee, was this issue in Eau Claire dealing with a Minnesota financial institution or not?

Mr. LEE. Yes.

Mr. VENTO. That is what I thought.

So I note the comments that were made about that issue, so I wanted to make sure I knew who the principal participants were. I wasn't—it didn't dawn on me that that was in—because it wasn't portrayed that way in the local back in Minnesota so far as what was going on in terms of this conversion activity.

But the concern is that there is then—I mean to me, I think that it would be—we ought not to miss the point here, Mr. Chairman, in terms of these mergers which I raised earlier, nor in the issue in terms of what is happening. I, you know, I mean the issue that is taking place in Ohio, Mr. Lee, is there certainly a parallel commitment or parallel activity in your State with regards to—I mean obviously we know with regards to Eau Claire I guess that it was a Minnesota institution, but is there a parallel situation with a lot of different proposals being put and mergers being sought and so forth, or do you believe it is noble capital-raising efforts?

Mr. LEE. No, it is neither one. We have more than sufficient capital. The conversion process is right now more readying themselves for future expansion and acquisitions, I think.

But from the mutual conversion standpoint, we have none in the works, and I have heard of none. We had a few conversions and acquisitions by banks, but only one merger conversion and that was a couple of years ago.

Mr. VENTO. Mr. Drumm, of course, the reason is that Ohio just provided by a law for the conversion of the State savings banks from mutual to stock, so they just facilitated this process. I don't know all of the nuances of it, but they at least have a recent effort, is that correct?

Mr. DRUMM. Yes. Mr. Vento, the law became effective in October 1991. We have so far converted only 20 of the mutuals to savings and loans.

Mr. VENTO. What is the value of the institutions that have been subjected to this conversion, not the merged institution like Provident? I know that is a big bank.

Mr. DRUMM. We have only three that we are actually converting from mutual to stock. There were two freestanding, no acquisition or anything involved, and the third was the acquisition by Provident of an institution called Heritage. The reason I mention that, there are offers being bandied about all over the State, to me it indicates that there is very little market out there, very little interest on the part of those institutions that are being approached. They don't want any part of what they call a takeover by a financial giant, by Ohio's standards.

Chairman NEAL. Would the gentleman yield?

You know, in one situation in North Carolina that I am familiar with, and there have been a number, an institution—a mutual converted to a stock form, and the stock came out at $10, and then very quickly it went up to—I don't remember the exact numbers, but $12, $14, something like that. And then within a very short pe-

riod of time, a couple of years, a bank offered $50 for the stock. So the stockholders did very well.

Frankly, I don't see anything wrong with that. That was all done out in the open; everyone had a fair opportunity to participate, as I understand it. I don't know all of the details of it. But that is my general understanding, that everyone had equal opportunity and so on.

I mean it is just hard to see that anyone was harmed by this; everyone felt like they were advantaged. The bank paid what they wanted to pay, the stockholders got what they wanted. I mean I just don't see anyone was hurt by it. The institution was strengthened considerably at each stage in the process, so I think ultimately the taxpayers' potential liability was reduced.

There are some other deals, these so-called merger conversions where it looks like—and there again, I am not aware of all of the details—but it looks like the banks are able to pick up savings banks for almost nothing, are able to get a big chunk of new net worth for almost no cost or no risk. Is that correct?

Mr. LEE. Yes, I think it is. I don't know that it goes on all over the country, and I don't know to what extent it happened even in North Carolina. I am not privy to information on the inside down there. But a merger acquisition is a strange transaction, and generally, the depositors are the ones that are adversely affected the most.

Chairman NEAL. Well, what are the equities here? I guess this is why we are involved in this thing.

I can't find that the Federal Deposit Insurance Corporation is in danger by any of this so far. I mean if I am missing something, I want to learn about it. It seems to me we are involved in this because of the equities involved. What do you all think? Who do you represent?

Do you feel like that you have the depositor's interests in mind, or are you primarily interested in the management of these institutions or the stockholders or the taxpayers? Who do you represent?

Mr. LEE. As a State regulator, I think I have two responsibilities: To the consumer, to the residents of Wisconsin, but also to the institution to make sure that it remains healthy. I try to weigh that in establishing priorities in a conversion transaction.

As I said, a portion of the transaction is set aside for management to make sure that that management stays there and operates the institution after the conversion with that flush of new capital and stays within its business plan and stays healthy. The majority of the stock goes to the depositors. They are the ones that have the ability then to make the quick gain and get out of the system.

Chairman NEAL. Management, you know, in one of the cases that we looked at, a management got—in fact, several of the cases we looked at, management had been there many, many years, 30 years or so, and they had no intention of staying. They were getting a big payoff, it looked to me like this may be a little unfair. I don't know. I can't read minds. Let me put this in a more—they weren't getting paid to stay there, I can say that, because a lot of them had been there 30 years or so.

They were getting big bonuses and then something else happened. They agreed to be taken over by a bank. And you know, it

is hard to read motivation, but just on the surface of it, it appeared that they might have been getting something for their willingness to recommend that their institution be sold to these banks.

Mr. LEE. That is always a possibility.

Chairman NEAL. A real cynic might look at it that way.

Mr. LEE. That is outside of the conversion process, that we really not have much to say about that until the offer comes in.

Mr. VENTO. Mr. Chairman, if I could just wind up. I think the issue with Heritage, at least according to the news stories, was that the appraised—the merger conversions are very appealing. We can certainly get the institution for relatively nominal amounts. And Provident appraised Heritage at $5.7 million. They expect to spend about $1.6 million to acquire it, and that is 15 percent of the free stock and a 15-percent discount to depositors and managers.

Then you start reading about the compensation package to the officers, it goes on and on. They are getting about $900,000 in issued stock and various types of other options. I think the concern is that this—if this were to become a model in Ohio, there would be a lot of concerns considering the number of mutuals eligible to convert. As was pointed out earlier, very often when an individual opens an account with a mutual and they sign over a proxy at that time. There is no process. It is a mutual in name only and there is very little participation other than by the office of the executives and we have to rely on Mr. Drumm and Mr. Lee in these State-chartered savings banks to do a good job. I think they probably try to, but they have to operate within the power and the authority that they have.

Mr. LEE. Well, I think while we do have rolling proxies, during the matter of a regular conversion, every depositor is provided with the forms to revoke that proxy and to vote on the conversion issue. The problem is that the vast majority of the members of the institution don't really care whether it converts to a stock institution or not. They are not interested in buying stock. They have their accounts there. They will continue to deal with the institution.

Mr. VENTO. I understand the problem in terms of——

Mr. LEE. And then you have the other end of it.

Mr. VENTO. Apathy.

Mr. LEE. Those depositors who have substantial funds on hand and have the opportunity to make a lot of money. And in Security's case, 12,000 people bought stock in the institution. Three-fourths of those got everything they asked for, because it was well over subscribed, it had to be ratcheted down, based on deposit balance. But there is an awful lot of profit to be made out there by an awful lot of people in these transactions. So there will be a group within the institution promoting the conversion, and those are a group of depositors.

Mr. VENTO. But I think, Mr. Chairman, the point is that these are not mutual participants; they are often very much motivated by substantial, inordinate benefits that may be thrown to them. I understand apathy when I see it. Someone asked me what the definition was of someone that was apathetic, and I said I don't know and I don't care.

Chairman NEAL. Mr. Barrett.

Mr. BARRETT. Thank you, Mr. Chairman. Mr. Lee, you were talking about the role that your office plays in making sure that they are capitalized. Again, my question to you is I don't see what the difference is from a public—or from an economic standpoint if the funds come from account holders or from insiders, from the capitalization standpoint.

Mr. LEE. From a capitalization standpoint, it doesn't make any difference at all.

Mr. BARRETT. OK. And your practice is to set aside stock from management's 5 percent is my understanding; is that correct?

Mr. LEE. Well, we have allowed up to a 5-percent management recognition program, but that is pretty much a giveaway, that is a freebie. We have also set aside a small part of the transaction for management to purchase it at the offering price to make sure that they have a stake in the institution. In Security's case, that amounted to a 5 percent management recognition plan and a 7 percent purchase by management so that the top management people in the organization when it was over owned 12 percent.

Mr. BARRETT. Earlier you said, I think you used the figure up to 80 percent of the stock could be purchased by——

Mr. LEE. In that case there was another 7 percent MRP bringing it to 19, leaving 81 percent through regular depositors.

Mr. BARRETT. Which institution was that?

Mr. LEE. Security.

Mr. BARRETT. Security. What are the other ranges? Have there been any others that have gone higher than 80 percent?

Mr. LEE. I don't know offhand.

Mr. BARRETT. And then finally, a basic question. Again, this goes back to my first question.

Do you think we should be doing something to ensure that the true owners of these institutions, the moms and dads and grandmas and grandpas who have put their money in these institutions over the years because they are conservative people, and have helped these institutions grow and would never in a quad-zillion years want to buy stock, help them get something?

Mr. LEE. I guess I look at it as a democratic process. If they are the owners, you put it to a vote and the majority wins.

Mr. BARRETT. OK. Then my followup question there, it seems as though that proxy handling is different in Wisconsin than it is in Ohio.

Mr. LEE. Yes, it is.

Mr. BARRETT. What is the public policy reason for that. It seems that Ohio—frankly, I am more impressed by the Ohio practice, which seems to have an affirmative recognition that this is big, that this isn't just something that you should let float by. Wisconsin, frankly, seems to take the attitude well, let's just let this float by and the less people that know about it, the better.

Mr. LEE. I think we have taken the position that as long as the institution makes the effort to fully inform the depositors of all of the nuances within the transactions—and I don't agree that it is that difficult to read a prospectus, I think we insult the common depositor when we say that. But I think—I don't know where I was going with that one. I need a little help on that. Where was I going?

Mr. BARRETT. I don't know.

Again, my point is that there are people out there who don't want to purchase stock, and I think the Ohio practice of bringing this issue to them and saying all right, what do you want to do now with your price.

Mr. LEE. Yes. The rest of that would have been I don't think the result would have been any different if you go to the Ohio practice.

Mr. BARRETT. OK. Thank you.

Chairman NEAL. Just one other question. Who do you think owns these things? Who owns a mutual?

Mr. LEE. The depositor.

Chairman NEAL. The depositors own it in your State. Is that the same in Ohio?

Mr. DRUMM. The same? Ohio, in a mutual?

Chairman NEAL. In a mutual.

Mr. DRUMM. Yes.

Chairman NEAL. So they do have some rights?

Mr. LEE. Absolutely. We try to protect their rights and at the same time protect the rights of the institution and show some recognition for the people who brought the institution to where it is without any significant penalty to the regular deposit holders.

Chairman NEAL. We may have another couple of questions for you in writing. Could we submit those and have you help us with them?

Mr. DRUMM. Certainly.

Mr. LEE. Any time.

Chairman NEAL. Thank you all very much for being with us today.

Mr. DRUMM. Could I just make one more comment?

Chairman NEAL. Yes.

Mr. DRUMM. This is in response to Mr. Vento's statement regarding the Provident/Heritage deal that has gained so much publicity, if you will. What appeared in the press is not what actually happened in practice. What I will do is send to the subcommittee members a copy of the actual deal as it was struck.

Chairman NEAL. OK.

Mr. DRUMM. It is a far different story when you see that.

Chairman NEAL. Thank you. We would like to have that.

Thank you all very much for coming.

Mr. DRUMM. Thank you for inviting us.

Chairman NEAL. Our next panel is comprised of Mr. Chris Lewis, banking and housing policy director for the Consumer Federation of America. Mr. William Kostiw, who is a depositor at Green Point Savings Bank, Flushing, New York, is trying to get here, but I believe his flight was delayed because of the weather; and Mr. David Carson, chairman and chief executive officer, People's Bank, Bridgeport, Connecticut; and vice chairman of Savings and Community Bankers of America. His plane was hit by a deicing truck, I understand, so he is delayed, and we understand that another witness, Professor Jonathan Macey, who is the DuPratt White professor of law of Cornell Law School is also delayed. So our panel is a little smaller than we had originally planned, but we are sure we will make up for it in quality.

So we have two witnesses, Mr. Brian Smith, who is the policy director of the Savings and Community Bankers of America; and Mr. Chris Lewis of the Consumer Federation of America.

Gentlemen, I want to welcome you all this morning. We will put your entire statements in the record and ask in the interest of time that you summarize and give us a little time for questions and answers.

Mr. Lewis, do you want to take off?

STATEMENT OF CHRIS LEWIS, BANKING AND HOUSING POLICY DIRECTOR, CONSUMER FEDERATION OF AMERICA

Mr. LEWIS. Thank you, Chairman Neal. You do have my statement and I will attempt to summarize it in a few minutes.

Mr. Chairman, as you know, the Consumer Federation very much believes that the Banking Committee took the right steps in 1989 to reform the savings and loan industry and to put an end to many of the high-flying schemes of the last decade that drained deposit insurance funds, but I think today's hearing points out that part of that reform job has yet to be completed.

One area of abuse, the conversion of mutual institutions into stock companies, was left untouched by the 1989 reforms, and this oversight, however accidental, has turned into a wonderful furlined playpen for S&L insiders and stock manipulating, Wall Street fast-buck artists.

Most, if not all of this activity, is perfectly legal because legislatures and their various regulatory agencies have failed to adequately deal with the problem and have left a mishmash of weakened and conflicting rules on the books that have provided a welcome mat for the sharp dealmakers. Fair play has often gone out the window in this massive conversion lotto with the odds and all of the winnings in favor of the insiders.

The OTS, under Acting Director Fiechter, does deserve credit for leaping into the jaws of this feeding frenzy. But despite their best efforts, the OTS needs help in the form of statutory and across-the-board safeguards that will protect the depositor, the real owners, in these mutuals and the safety and soundness of the financial system and prevent further unfair and unearned windfalls from lining the pockets of the insiders.

Unfortunately, many of the States, with perhaps the noble exception of New York, and apparently OTS's sister agency, the FDIC, to date, have taken a "see no evil and hear no evil" attitude toward these ongoing abuses. Much of the concern today, as has been pointed out earlier this morning, centers around not only standalone conversions, but also merger conversions and it is this activity that is most often found in the headlines about feeding frenzies.

We identify four areas of principal abuse that dot the conversion landscape. First, insiders obtaining control of institutions through conversions; second, unfair and excessive deals offered insiders to induce officers and directors to push for conversions without regard to the best interests of depositors or their communities.

Third, fraudulent low-ball appraisals of institutions involved in the transactions, which permit holding companies to obtain mutuals at bargain basement prices. And, last, the limitation of

meaningful participation of account holders, the real owners, in conversion transactions.

The stories of lucrative payoffs to officers and directors have evidently created an almost irresistible urge for other mutuals to leap into the game, and we firmly believe that the subcommittee needs to look very carefully at whether this is good public policy or the proper way to build a financial system. Clearly, what the depositors are getting in these conversions is nothing more than the crumbs from the table, and as others have pointed out, not only has the conversion mania created a new and aggressive breed of insiders, but it has also spawned a sophisticated team of outsiders who roam the country opening accounts in institutions in hopes of cashing in on lucrative stock deals offered at discount prices in conversion.

As I noted in my written statement, one principal area of concern for us is the poor and often misleading disclosure given to mutual depositors of a proposed conversion to a stock company. Depositors have been both misinformed by management about the nature and consequences of a conversion and often are provided woefully inadequate time and resources to respond to management recommendations for conversion. The simple fact is that depositors are often at an overwhelming disadvantage to appreciate the significance of and to respond to proxy statements that are too often written in incomprehensible legalese and often delivered in junk mail packaging.

We believe that H.R. 3615 takes an important first step to curb the raging wildfires of greed that have been set in many States through the passage of liberal conversion statutes. The bill would provide for parity governing the conversion of mutual associations and this would, we hope, begin to curb the perverse incentives that are currently at play in the marketplace. We believe that the bill should certainly be passed, but we believe it could stand some modest improvement.

As was pointed out earlier, the OTS rules could stand improvement themselves, and the current bill does nothing to correct weaknesses in the Federal conversion regulations. In fact, under current OTS rules, management can walk away with virtually 50 percent of the stock in a conversion.

And we find, frankly, no public policy rationale for insiders having an advantage over depositor owners of mutual institutions in a conversion and we would recommend that the bill be amended to prohibit any preference for insiders in a conversion; insiders ought to participate just like a member of such an institution.

We would concur with Director Fiechter's recommendation this morning that the subcommittee consider a ban on merger conversions. These are obviously the most abusive conversion deals on the marketplace that violate general principles of market transactions. And as was pointed out in the previous discussion, many insiders are able to manipulate the voting on a conversion through the exercise of continuing or general proxies, and we believe that the subcommittee ought to consider the prohibition of the use of any continuing proxy in the voting on a conversion—in other words, that only fresh proxies should be able to be used for the approval of the conversion.

Finally, we also find merit in the discussion that occurred during the first panel surrounding the notion of having the book value of a mutual institution given back to a community in the course of a conversion. In short, the bill needs to ensure that conflicts of interest are removed from the marketplace before institutions considering conversion to stock form, that fair play be the rules of the game during the course of any conversion, and that this include fair valuations of institutions, fair disclosure, and adequate time for members of mutual institutions to respond to any recommendation, and that members have the option to have funds given back to their community.

I would be glad to answer any questions that you have.

[The prepared statement of Mr. Lewis can be found in the appendix.]

Chairman NEAL. Thank you, Mr. Lewis. Mr. Smith, we would like to hear from you.

STATEMENT OF BRIAN SMITH, POLICY DIRECTOR, SAVINGS AND COMMUNITY BANKERS OF AMERICA

Mr. SMITH. Thank you, Mr. Chairman.

As you know, I am not David Carson. I am pinch-hitting for him, and the collision between the deicing truck and the U.S. Air flight didn't create any casualties, but he apologizes for not being here.

I appreciate the opportunity to testify on H.R. 3615. This bill would specify that mutual banks that aren't regulated by OTS would be required to convert in accordance with regulations of the FDIC substantially similar to those of the OTS. Although the FDIC has begun the process of rule making in the area, there currently are no regulations governing these conversions, leaving such alterations in corporate status entirely up to State law, although the FDIC would automatically become the securities regulator of the converted entity. Our understanding is that the bill would be effective to its retroactive date of introduction and designed to ensure that the treatment of the depositors and institution insiders would track the OTS standard in all cases.

SCBA does not believe at this time that there is a problem in the conversion area that couldn't be cured through this appropriate action by the FDIC. On two occasions SCBA has urged the FDIC to issue curative rules. Because of the retroactive nature of H.R. 3615, until the FDIC does act, there will be a cloud over the whole area of non-OTS regulated conversions, even for companies that would willingly convert under OTS-type rules. This is regrettable and can deter the attraction of capital.

Consequently, we were encouraged that the FDIC, on January 24, did issue a proposed policy statement on mutual-to-stock conversions. The statement covered correct pricing of shares, apportionment of subscription rights and adequate and timely disclosure. It also specifically asked for comment on whether the FDIC should adopt an enforceable regulation governing these conversions, regulations that would closely follow the existing OTS standards.

We answered that question yes, because the conversion framework developed by the OTS is one that has served affected savings institutions, their members and their communities for 20 years and done so very well. It was developed in the light of substantial con-

gressional interest and has been consistently upheld by the courts as consistent with depositor rights. As Mr. Fiechter noted earlier, over 1,000 institutions have converted, bringing in over $16 billion in outside capital. Those capital resources served as a shock absorber against losses to taxpayers.

SCBA thus regards the availability of a stable, legal framework for conversions as a goal of the utmost importance. There are still over 1,200 institutions with approximately $230 billion in assets remaining in mutual form. Mutual institutions have proven over the years to be conservative, community-oriented companies because of their form of organization, are well able to adopt a long-range approach to business planning. We believe that the preservation of at least the option to remain as a mutual is very important.

However, mutuals can raise capital only through earnings. If one thing is clear in the aftermath of FIRREA, it is that capital is king. The ready access to additional capital provided by the conversion option is very important to mutual institutions in the event they do need that access to additional capital.

Despite the benefits that the OTS approach to conversion has offered over the years, it has been subject to some criticism as being insufficiently generous to depositors. The Federal Home Loan Bank Board, the OTS predecessor agency, long ago rejected the idea of a free distribution of stock. Such distribution would add nothing to the capital distribution of the company.

The Bank Board was also concerned that the availability of such windfalls would have a disruptive and destabilizing effect on the mutual segment of the business. Those concerns about stakeout deposits for conversions under existing rules would be exacerbated by the possibility of a free distribution.

In addition, such a distribution would create substantial additional pressure that might make the mutual form of organization unviable.

The primary objective of the conversion process should be to produce a stronger depository institution in a position to provide home lending and other community banking services that the entity was chartered to deliver. We would be troubled by specific CRA contribution mandates loaded specifically onto converting institutions, though as with all applications, CRA compliance is a relevant issue.

As I noted, SCBA has asked the FDIC to issue conversion rules. Specifically, we would like the FDIC, rather than to preempt State law entirely in this area, to undertake an examination of State law regimes and permit those that are substantially similar to the OTS standard to continue in force. If such a State framework met these standards, conversions could proceed under that State framework. Otherwise, they would have to be processed by the FDIC under its regulations. This would be less intrusive than a total preemption, leaving room for accommodation to legitimate variations desired by State legislators and regulators, and leave some flexibility in the dual banking system.

We also believe that some clarification of the retroactive impact of the legislation would be useful in permitting existing deals to go forward in a timely manner.

Finally, we would like to mention that the current trend away from OTS jurisdiction has often been mischaracterized. Originally, it was alleged that the desire was to obtain broader investment authority. That was not the case because even though such broader investment authority would not be granted, institutions still continued to convert.

In addition, many institutions have made the switch, even though the State conversion rules, as in Illinois and Indiana, absolutely track existing OTS rules. So these institutions have not fled the OTS mutual-to-stock conversion standards.

The objective in these conversions is to escape OTS examination costs as the financial sector consolidates. These examination costs can be quite substantial for a small institution. As you know, many commercial banks over the years have similarly avoided national bank charters. This is part—indeed the essence—of the dual banking system, and it should be preserved.

Mr. Chairman, this concludes my summary of the prepared remarks and I would be happy to take any questions. Thank you.

[The prepared statement of Mr. Carson (submitted by Brian Smith) can be found in the appendix.]

Chairman NEAL. Thank you. To tell you the truth, I think both of you made very good statements. I don't really—I understand your positions, and I really don't have any questions. If we develop some, would it be all right if we got in touch with you and asked you to submit some for the record?

[The prepared statement of Mr. Kostiw can be found in the appendix.]

Mr. LEWIS. We would be delighted to.

Chairman NEAL. Well, I thank you very much for your testimony. The subcommittee will stand adjourned subject to the call of the Chair.

Thank you again very much for coming together.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

APPENDIX

January 26, 1994

OPENING STATEMENT OF THE HONORABLE STEPHEN L. NEAL ON H.R. 3615 MUTUAL BANK CONVERSION ACT

Wednesday, January 26, 1994

The Subcommittee meets this morning to continue its hearings on H.R. 3615, the Mutual Bank Conversion Act, and on the issue of mutual to stock conversions of savings banks generally.

Last Thursday, the Subcommittee held a field hearing in Winston-Salem, North Carolina, and heard testimony from depositors, bankers, and state regulators. Much of that testimony gives rise to concerns that the insiders at mutual savings banks, unless adequately supervised, can take advantage of their position and unfairly profit from converting an institution from mutual to stock form.

More than two months ago, I wrote to the Federal Deposit Insurance Corporation, asking it to take a more active role in regulating these transactions. Not until Monday, however, did the Board of the FDIC act, and then only to publish for comment a very disappointing proposed policy statement. That statement almost completely ignores the widespread allegations of insider abuse in these transactions. The proposed policy statement drew sharp criticism from FDIC Board Member and Comptroller of the Currency Eugene Ludwig, and Banking Committee Chairman Henry Gonzalez. I share in their concerns regarding this statement.

In contrast, to the indecisive action of the FDIC, yesterday New York State Banking Superintendent Derrick Cephas took strong action after he determined that the trustees of Green Point Savings Bank would receive "extensive personal benefits that . . . were inconsistent with New York law." As a result of Superintendent Cephas' actions, the trustees and executive officers of Green Point will receive no free stock, or even be able to purchase stock in Green

Point as part of the conversion.

Superintendent Cephas was due to be one of our witnesses this morning. Due to the need to continue to work on supervision of the Green Point conversion he is unable to appear, but has indicated that he will submit a written statement for the record. We will hear from a depositor of Green Point who opposed the conversion as proposed. Management of Green Point was invited to appear as well, but declined to appear, citing concerns over on-going litigation.

There have been mutual to stock conversions in other states that have raised concerns. In one transaction, Mutual Savings Bank of Milwaukee proposes converting from a state chartered mutual savings bank to a mutual holding company owning virtually all the stock of the bank itself. The only stock in the savings bank to be sold will be offered solely and exclusively to ten officers and directors. Depositors will be unable to purchase a single share of stock. Additional stock will be put into an employee stock ownership plan. This transaction would bring $2.3 million into the bank, while costing the bank $17.8 million. In short, this proposed transaction not only cuts depositors out, but reduces capital in the institution. This is a transaction that could not be done under current OTS regulation.

While there have been a number of outrageous transactions approved by state regulators, I am not entirely certain that additional Federal regulation is necessary.

The problem does not seem to be with inadequate state laws, but rather with inadequate state supervision. The actions of New York this week show that an aggressive State Banking Superintendent can prohibit insider abuse. At the same time, the hearing in North Carolina and stories from other states show that lax state supervision provides little or no protection to the depositor-owners of mutual institutions.

The States have an opportunity to prevent abuses. If the States fail to act, the FDIC has the authority and ability to prevent abuses. If those supervisory agencies are reluctant to exercise their authority then Congress will have no alternative but to step in and assure that conversions are conducted fairly for all parties.

CAROLYN B. MALONEY
14TH DISTRICT, NEW YORK

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AND URBAN AFFAIRS

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OPENING STATEMENT

Subcommittee on Financial Institutions

Hearing on HR 3615, the Mutual Bank Conversion Act
January 26, 1994

Thankyou Mr. Chairman. Six months ago, many would have viewed today's hearing as a discussion of an unpublicized and almost arcane area of Federal banking law. But the recent conversion plan offered by Green Point Savings Bank, the largest mutual savings bank in the Nation, and the attempted takeover of Green Point by Republic Bank has put this issue on the lips of everyone connected with the banking industry.

The Green Point conversion dramatizes the immense amount of money that can be involved in mutual bank conversions.

Throughout this entire process, New York State Banking Superintendent Derrick Cephas has acted forcefully to protect the interests of the depositors of Green Point, who will also become the shareholders. He first ruled Republic's bid illegal and this past Monday voided the compensation for Green Point's directors as being too excessive.

Much of the urgency in Congress today to act on mutual bank conversions is based upon the lack of formal regulations governing the compensation that can be paid the directors of a mutual savings bank. Since the bank is technically not owned by anyone, the directors do not have to answer to anyone.

And while I support Congressional action in this area, I don't believe that we should hastily rush to change banking regulations in the heat of the publicity of this particularly tangled conversion.

Again, my thanks to Chairman Neal for scheduling this very timely hearing.

EMBARGOED
until Jan 26, 10 am

Testimony
of
Jonathan L. Fiechter, Acting Director
Office of Thrift Supervision

concerning

Mutual-to-Stock Conversions

before the
Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance
of the
Committee on Banking, Finance and Urban Affairs
United States House of Representatives

January 26, 1994

Office of Thrift Supervision
Department of the Treasury

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INTRODUCTION

Good morning, Mr. Chairman and members of the Subcommittee. Thank you for inviting me to provide the Office of Thrift Supervision's (OTS) views on regulating mutual-to-stock conversions.

For the past 20 years -- since the former Federal Home Loan Bank Board (FHLBB) implemented its mutual-to-stock conversion regulations in 1974 -- mutual-to-stock conversions have been a successful vehicle for bringing new capital into the thrift industry. Only a handful of mutual-to-stock conversions were conducted prior to 1974; however, since then, over 1,000 mutual savings associations have converted to the stock form of ownership, in the process raising approximately $16 billion in new capital. Almost 300 thrifts have converted in the last four years, raising nearly $5 billion in capital. During that same time, an additional 15 mutual institutions have formed mutual holding companies, raising $105 million.

As these numbers suggest, a principal benefit of an institution converting from the mutual to the stock form is raising capital, a result that can otherwise be difficult for mutuals to achieve. Mutual associations can increase their equity base only from retained earnings. This can be a lengthy process. Capital-deficient mutuals, in particular, have an incentive to promptly raise capital in order to achieve capital adequacy and thus avoid the wide range of regulatory and supervisory actions that regulators take against inadequately capitalized institutions. While a mutual may issue subordinated debt, the interest payment feature of the debt and the limitations on its use for meeting regulatory capital requirements may make it unattractive or inadequate to meet the institution's capital needs.

Often a mutual-to-stock conversion by a healthy institution results in a quick appreciation in the value of the stock. This makes the transaction attractive to the institution's insiders because of the opportunity for those insiders to realize a profit -- often a substantial profit -- on the stock they purchase or are otherwise given in the form of management benefit plans in the conversion transaction. This aspect of the transaction has recently drawn a great deal of attention. It is, as I will shortly discuss, one of the focal points of OTS regulation. I believe it would be useful to begin, however, with an overview of the mechanics of a mutual-to-stock conversion.

OVERVIEW OF THE MUTUAL-TO-STOCK CONVERSION PROCESS

Types of Conversions

A mutual-to-stock conversion may be structured as a standard conversion or holding company conversion, a merger conversion, or a mutual holding company reorganization.

A standard conversion or holding company conversion simply involves a mutual institution converting to stock form -- the conversion stock offered for sale is the stock of the converted institution.

A slight variant that is more common today involves a mutual institution converting to the stock form in connection with the formation of a holding company. In this type of transaction, called a holding company conversion, stock of the holding company is offered for sale and the converting institution becomes wholly owned by the holding company.

A second form of conversion is a merger conversion, involving the acquisition of the mutual institution by a stock institution. In this case the stock of the acquiring institution (or its holding company) is issued in the conversion and the mutual thrift is merged into the acquiring institution.

Finally, a mutual institution may undertake a mutual holding company reorganization. This transaction is a structural hybrid of a standard or a holding company conversion. A mutual institution charters a subsidiary stock institution and transfers substantially all of its assets and liabilities to the stock subsidiary. The original mutual institution then becomes a mutual holding company by adopting a new mutual holding company charter. In effect, the mutual account holders of the thrift become the owners of the mutual holding company. This structure permits the resulting stock subsidiary to issue up to 49.9% of its stock to persons other than its mutual holding company parent. Generally, under OTS regulations, mutual holding company transactions are subject to the same requirements of the conversion regulations applicable to other types of conversions.

The Conversion Transaction

The decision to convert a mutual institution is typically initiated by the institution's board of directors. After a mutual's directors decide to convert, they adopt a plan of conversion and file a conversion application with the appropriate regulator and notify the mutual's account holders.

The conversion application filed with the regulator usually includes the plan of conversion, a copy of the proxy statement (and all proxy soliciting materials) to be sent to account holders seeking their approval of the conversion, and an offering circular registering the conversion stock. In addition, the institution is generally required to provide some form of valuation of the conversion stock.

If the conversion application receives regulatory approval, the plan of conversion is usually submitted to a vote at a special meeting of account holders. In most cases, a majority of the total outstanding votes of account holders is required to approve the plan of conversion. Account holders may vote in person or by proxy. In the event that account holders do not return the proxy materials, attend the special meeting, or otherwise revoke so-called "running" proxies -- proxies executed by account holders at the time they opened an account -- management may use the running proxies to vote for approval of the conversion. Federal law requires management to inform account holders of the intent to vote running proxies.

In the conversion process, priorities and incentives are typically established with respect to the purchase of conversion stock. Priority purchase rights may be extended to account holders, the mutual's officers and directors, employee stock benefit plans, such as employee stock ownership plans (ESOPs) and management recognition and retention plans (MRPs), and to members of the general public residing in the communities where the association has offices. Purchase priorities are established to permit individual members of one group to purchase up to a designated amount of stock before members of the group next in priority may make any purchases.

For example, account holders could be provided first priority to purchase the conversion stock through the receipt of nontransferable subscription rights. In the event of an oversubscription of conversion stock by account holders (if account holders offer to purchase more stock than the total conversion stock offered), shares would be allocated among the subscribers on a pro rata basis.

Under Federal law, upon consummation of a conversion, an institution is required to establish and maintain a "liquidation account" -- equal to the retained earnings -- for the benefit of existing account holders. This account is intended to recognize the intangible ownership interest of mutual account holders in the net worth of an institution prior to conversion. Each mutual account holder has a subaccount in the liquidation account based on his or her pro rata portion of the institution's net worth prior to conversion, adjusted annually to reflect account withdrawals.

I might note that a conversion does not impact the normal day-to-day operations of an institution. Account holders continue to hold accounts in the converted institution in the same amount and at the same rate of return and general terms. Borrowers' loans are also unaffected by the conversion. The amount, interest rate, maturity, security and other conditions of outstanding loans are unaffected by the conversion.

HISTORY OF THE FEDERAL CONVERSION REGULATIONS

Prior to 1948, all savings associations operated as mutual associations. When Congress authorized savings associations to convert from the mutual to the stock form in 1948, concerns were immediately raised regarding conversions and the distribution of the net worth of the mutual institution among potential owners of the new stock. To the extent that holders of the new stock in converting institutions realized immediate gains on their investments, the result could be increased volatility in thrift deposits as would-be investor/depositors shifted funds among thrifts in search of soon-to-be converted institutions. In addition, the potential for large gains would place undue pressure on mutuals to convert, and would increase the potential for abuse by insiders seeking to reap a disproportionate share of any gains resulting from conversions. Because of these concerns, the FHLBB and Congress imposed various moratoria on conversions through 1974. As a result, between 1948 and 1974, only a small number of conversions were completed.

In an effort to address these concerns, the FHLBB proposed conversion regulations and held public hearings on them in 1973. At the same time, Congress also held hearings on the need for legislation in this area. Following the agency and Congressional hearings, the FHLBB revised its proposed conversion regulations in late 1973, and adopted them in 1974.

It was generally believed that the new regulations adequately addressed the problems arising from conversion "windfalls." As a result, Congress allowed its conversion moratorium to expire on June 30, 1974; these regulations continue in effect today.

KEY SAFEGUARDS CONTAINED IN OTS CONVERSION RULES

The conversion from a mutual form of ownership to stock ownership creates several concerns. In a mutual-to-stock conversion, the mutual's insiders -- its directors and managers -- are the parties who initiate and set the terms for the sale of the stock. But they are also potential purchasers of the stock. They, like any purchasers, are motivated to buy low in order to maximize the stock's value to them in the aftermarket. The account holders who have an ownership interest in the mutual institution are also potential stock purchasers. As such, they too will benefit from the stock's appreciation in the aftermarket.

Thus, when a mutual institution converts to stock form, the transaction is one-sided. There are "typically motivated" buyers for the stock, but in a mutual conversion there are no "typically motivated" sellers, that is, sellers interested in achieving the highest possible price for the stock. The market thus does not exert discipline over the transaction -- the usual tension between seller and buyer is lacking.

It is this absence of market discipline that is most troublesome and creates the potential for abuse. OTS regulation is designed to counteract this tendency by imposing limits or controls on insiders' activities in connection with mutual-to-stock conversions. The overarching control is that these conversion transactions cannot be consummated without OTS approval. To receive OTS approval, an institution must meet the following conditions:

- Purchases by officers and directors in the aggregate are limited to between 25% and 35% of the total conversion stock offering, depending on the asset size of the converting institution. Moreover, no person, alone or acting in concert with others, may purchase more than 5% of the conversion stock -- and the institution may set a lower purchase limitation. Finally, in no event may a converting institution loan funds to any person for the purpose of purchasing its conversion stock.

- In addition to the individual and aggregate management purchase limits, a converting institution may establish one or more tax-qualified ESOPs that may purchase, in the aggregate, up to 10% of the conversion stock on a first-priority basis. An institution may also establish non-tax-qualified plans, but these do not have any purchase priority, and stock allocable to management must be aggregated with other conversion stock for purposes of individual and aggregate management purchase limits.

- Specific subscription priorities are established for the purchase of conversion stock. First priority (after any tax-qualified ESOP purchases) goes to savings account holders with the institution at least 90 days prior to the date of adoption of the plan of conversion. The second priority goes to all other account holders. A third priority may be established for management and employee stock purchases. Finally, any stock not sold in the subscription offering must be sold to the public.

- The conversion stock must be sold at a price equal to the estimated <u>pro forma</u> market value of the converting institution's stock, based on an independent valuation, on or about the date of the conversion. The appraisal is reviewed by the OTS to ensure there is adequate data to support the estimated <u>pro forma</u> market value, for conformity with appraisal methodology and documentation standards, and to verify the appraiser's experience and independence.

- A majority of account holders must approve the conversion, and account holders must be furnished with a written proxy statement describing operation of, and their rights and role in, the conversion process. Proxy materials used to solicit votes must comply with the disclosure requirements of the Federal securities laws and specific thrift disclosure requirements established by the OTS, and must be reviewed and cleared by OTS staff prior to use. In addition, management may only use pre-existing "running"

proxies to vote on the conversion if account holders do not vote their special conversion proxies.

- o As with the proxy materials, the offering circular used to solicit account holders and others to purchase the conversion stock must comply with the Federal securities laws and specific OTS requirements, must contain audited financial statements, and must be approved prior to issuance.

The OTS conversion regulations, comprehensive in scope and governing all aspects of the conversion process, set forth specific and detailed standards that have been consistently imposed without exception as regulatory requirements in conversion transactions over the years. These key regulatory controls are consistent with our understanding of the purpose and objectives of Congressional intent in allowing the mutual-to-stock conversion moratorium to expire in 1974.

CONVERSION REGULATION ISSUES

The nature of mutual-to-stock conversions and the dynamics of the marketplace make it difficult to write regulations in this area. In administering the conversion program, the OTS continuously reviews the need for changes to its rules and remains open to suggestions for further improvements. OTS, based on its experiences with its conversion program, has revised the conversion regulations several times since 1974. We continue to believe that minimum regulatory standards in the conversion area are desirable to curb the potential for abuse inherent in the skewed economic incentives in mutual-to-stock conversions. If such conversion standards are appropriate for OTS-supervised mutuals, they are presumably appropriate for other mutual institutions that convert.

OTS's rules govern only mutual-to-stock conversions of OTS-supervised thrifts. They do not apply to conversions undertaken by state savings banks. OTS supervises approximately 850 Federal- and state-chartered mutual savings associations. Given the popularity of mutual-to-stock conversions, many of these mutual institutions may choose to convert to stock form. If these institutions change to a state savings bank charter before they convert to a stock institution, they will be subject to state conversion rules.

Differences in State and Federal Conversion Laws

A number of states closely follow Federal conversion rules. Some, however, do not. Differences in those states that do not follow the Federal rules primarily involve:

- o the rights and priorities of mutual account holders to purchase conversion stock;
- o the amount of conversion stock that institution insiders may purchase;

- o the amount of permissible stock incentives that may be given to management; and
- o the valuation of the converting institution (and conversion stock) at the time of the conversion.

In several states, insider purchasers are not subordinated, and in certain instances are placed ahead of account holder subscriptions for the conversion stock. At least one state imposes no limit on the aggregate amount of insider purchases; and although there is a 10% limit imposed on ESOP purchases, there is no express limit on the combination of insider, ESOP and MRP purchases. Some states do not appear to have any regulatory standards governing management compensation arrangements in conversion transactions. Others have standards that authorize purchases far in excess of applicable Federal rules.

Under Federal rules, insiders are restricted from purchasing, in the aggregate, more than 25% to 35% of the conversion stock, depending on the institution's asset size. In addition, tax-qualified ESOPs are limited to 10% of conversion stock, MRPs are limited to 3% or 4% (depending on the thrift's capital position) of conversion stock, and combined ESOP and MRP purchases are limited to 10% to 12% of conversion stock (depending on capital). Thus, in no event could aggregate insider, ESOP and MRP purchases exceed 47% of the conversion stock. That amount could only be purchased if account holder subscriptions were limited and did not exceed 53% of the conversion offering. More typically in OTS-supervised conversions, management ends up with significantly less than 47% of the conversion stock due to high depositor subscriptions in this process.

Another difference in Federal and state conversion regulation is the method for pricing the conversion stock. Under Federal regulations, a converting institution must issue and sell its stock at a total price equal to the estimated pro forma market value, based on an independent valuation, of the stock in the converted thrift. Approved and standardized valuation procedures must be used to make this valuation determination, and the appraisal report must include a complete and detailed description of the appraisal methodology employed. The appraisal is reviewed by the OTS to assess the sufficiency of the data to support the appraisal methodology utilized to value the institution for purposes of stock sold.

Although most state laws require that conversion stock must be sold at the estimated pro forma market value of the stock in the converted institution, appraisal requirements vary from state to state. As a result, it appears that the manner in which state savings banks are valued at the time of their conversion is inconsistent.

Recent Trends in Charter Conversions to State Savings Banks

State-chartered savings banks traditionally were BIF-insured institutions, located primarily in New England states. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), however, provided the authority for a savings association to become a state savings bank; these changes in charters have been informally referred to as "Sasser" transactions. As a result of this FIRREA authorization, a number of states outside New England have sought to entice savings associations to shift to state savings bank charters.

Increasingly, mutual institutions that are choosing to convert to stock form find it advantageous to do so under state rules. Because Federal supervision of institutions that change to state savings bank charters shifts to the Federal Deposit Insurance Corporation (FDIC), OTS does not have comprehensive information on subsequent conversions by these institutions that have left our jurisdiction. We have observed, however, that over the past several years, the number of OTS-supervised mutual institutions that have changed to state savings bank charters has increased dramatically. For example, 51 North Carolina mutual institutions recently removed themselves from OTS jurisdiction in favor of North Carolina's state savings bank charter. Of these, nearly half subsequently undertook a conversion -- 8 converted to stock institutions and an additional 16 were acquired by another institution in merger conversions. During the same time, only two North Carolina mutuals supervised by the OTS undertook similar conversions. Similar patterns exist in Pennsylvania, Wisconsin and New Jersey.

Of course, differences in Federal and state conversion standards are not the only incentives for OTS-supervised thrifts to change charters. Institutions changing charters can shift supervisory expenses. For instance, OTS-supervised thrifts, whether Federal- or state-chartered, pay for their examinations through explicit fees. By contrast, the FDIC's expenses of examining state savings banks are borne by the deposit insurance fund and thus by all insured institutions that are members of the fund. OTS-supervised thrifts are required to hold stock in the FHLBank System and thus, indirectly, must contribute to the Resolution Funding Corporation and affordable housing obligations of the FHLBank System. Thrifts that change to state savings banks, by contrast, may redeem their FHLBank stock and avoid such obligations.

CONCLUSION

Mutual-to-stock conversions provide an opportunity for an institution to raise capital. Mutual-to-stock conversions may also tempt an institution's insiders to engage in transactions that transfer an inappropriate amount of the institution's value to the institution's insiders.

The OTS mutual-to-stock conversion regulations reflect standards and safeguards developed over the years to counteract the lack of market discipline in the process and to respond to the potential for abuses in thrift conversions. Some states do not provide depositors with the same level of safeguards.

We believe there is no compelling reason to permit what amounts to "regulatory arbitrage" that may disadvantage depositors or their local communities. To the extent that there have been abuses in the conversion process, consistent standards should be applied to correct those abuses. The issue is not OTS rules versus state rules but identifying what abuses, if any, exist and applying uniform rules even if that means changing OTS rules.

TESTIMONY OF

ANDREW C. HOVE, JR.
ACTING CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

ON

MUTUAL TO STOCK CONVERSIONS

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND DEPOSIT INSURANCE OF THE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

JANUARY 26, 1994

Good morning, Chairman Neal and members of the Subcommittee. On behalf of the Federal Deposit Insurance Corporation ("FDIC"), we appreciate this opportunity to testify regarding institutions that convert from mutual to stock ownership. We share your concern regarding the need to assure that the value in institutions that convert is fairly distributed. Depositors should be treated fairly and insiders such as management, trustees and employees should not obtain a disproportionate share. When an acquisition by another institution is part of the conversion, depositors need to be treated fairly in relation to the interests of both insiders and the acquiring institution.

Our comments begin with an explanation of the concept that in these conversions, somebody always gets something for nothing. It is not a question of "whether", but "who." To shed some light on whether insiders are getting more than they should of this "something" and, if so, what can we or should we do about it, we will consider who actually owns a mutual institution, look at the history of the Office of Thrift Supervision ("OTS") regulations, compare OTS rules on mutual to stock conversions to state rules, discuss the FDIC's authority to regulate conversions, explain the FDIC's recently proposed policy statement on mutual to stock conversions, and conclude with our views on HR 3615, the proposed legislation on conversions.

Let me say up front, that at this point the FDIC is neither opposed to nor in favor of action on this matter. We are looking for better understanding of this issue and would welcome guidance. There is clearly a public policy issue, namely depositor fairness. The question is whether it rises to the level of warranting uniform Federal intervention, especially in light of our efforts not to add to unnecessary regulatory burden. The answer is not yet clear. We would also like to point out that many conversions, particularly those by marginally or undercapitalized institutions, raise much needed capital that benefits the banks, the deposit insurance fund and the public at large. It is important that we do not place unnecessary roadblocks to these worthwhile conversions where capital is deficient.

A Basic Fact

In plain English, yes, there is a free lunch, in these transactions, as the equity that exists in a mutual institution (before it converts) is apportioned to the recipients of stock upon conversion. We may ask how this takes place since the recipients of stock are expected to purchase their shares at appraised value. Let me use an example to illustrate. Assume equity in a mutual prior to conversion is $1 million. If 100,000 shares are sold at $10 each, additional capital of $1 million will be raised and the total equity in the institution elevates

to $2 million. Thus, shareholders receive $20 of book value equity for each $10 share purchased or a total of $1 million in free equity for the 100,000 shares. Nothing really changes if we try to eliminate this windfall by raising the share price to $20. Total equity in the institution increases to $3 million for which shareholders pay $2 million; $1 million of free equity is still distributed. Regardless of how the shares are priced, we cannot eliminate the free distribution of equity.

The example is descriptive but admittedly over simplistic, since the appraisal process involves many more elements in arriving at an estimate of post conversion market value. In fact, we understand that the most important analytical method in arriving at estimated post conversion appraised value is the application of a market capitalization rate to projected earnings. For example, a market environment calling for a 10% rate of return on comparable investments will result in an appraised value of $30 on a stock earning $3 per year. Nevertheless, an appraisal, predicated on a capitalization of earnings or any other approach, results in an initial share price at an amount less than the post conversion equity value or book value. The marketplace valuation of share prices relative to book value can and does vary considerably depending on the economic cycles, current and anticipated industry earnings, and other factors. Fortunately, financial institutions are now enjoying healthy earnings and the economic climate is improving.

The marketplace takes this into account and, in the secondary market, is pricing many financial institution securities accordingly, at close to book value if not at or above book value. Thus, it should not be surprising that the initially issued shares of a converting mutual, especially in the current climate, often rise substantially above the initial appraised or purchase value, which, we remember, must be below book or equity value when a mutual institution converts.

Who Owns a Mutual Institution

Underlying the Federal Home Loan Bank Board's evolutionary approach to regulation of the conversion process is the implicit question of who actually owns a mutual institution. While mutual accountholders are treated as shareholders for some purposes, such as voting on certain types of organizational matters and entitlement to a share in the liquidation of the mutual's assets; on the other hand, they do not have power to sell their interest in the net worth of an operating mutual, do not receive dividends based on profits, and do not always have power to exercise full control over the mutual's management in the way other corporate shareholders can.

The ownership status of a mutual institution is therefore somewhat unclear. In some contexts it seems that ownership is represented by a larger bundle of rights and in other situations

an ownership interest is more accurately reflected by a smaller bundle. In the case of an accountholder in a mutual thrift institution, the bundle of rights representing ownership is considerably less than that of the typical corporate shareholder--at least under current law and practice. We also note that some parties would even argue that the worth of a mutual organization belongs to the undefined community and should be apportioned in some public interest fashion. Finally, we remember that mutuality is not unique to the savings institution industry. It is the standard for credit unions and is widely present in the insurance industry. Changes in the Federal regulatory approach over the years reflect this quandary over who truly owns the mutual and, in particular, its net worth accounts.

History of the OTS' Regulations on Mutual to Stock Conversions

In July 1948, the Home Owners' Loan Act of 1933 was amended to permit a federal savings and loan association to convert to a state stock-type association "upon an equitable basis." In the mid-1950s, the Federal Home Loan Bank Board (FHLBB) the predecessor of the Office of Thrift Supervision proposed its first set of regulations for the conversion process. In 1957, the FHLBB issued a revised version of its proposed conversion regulations to require that the entire amount of the stock to be issued be distributed, without payment, on a pro rata basis to the savings association's existing account holders. Any account

holder who did not want to receive stock had to be paid in cash for his or her share. The FHLBB adopted a final regulation in 1961, providing for a free distribution of the converting savings association's accumulated net worth. In 1962, a similar regulation governing conversions of state-chartered, FSLIC-insured institutions was adopted.

In 1963, the FHLBB imposed a moratorium on conversions based on concern that windfall profits could be made by a small group of insiders who initiated the conversion plan. The moratorium continued through the 1960s, as the FHLBB attempted to formulate conversion guidelines that would safeguard both the interest of the deposit insurance fund and the rights of account holders.

In 1972, the FHLBB announced its intention to terminate the moratorium upon the adoption of revised, final conversion regulations. In August 1973, however, Congress imposed a statutory moratorium on conversions. Nevertheless, the FHLBB adopted a comprehensive revised set of conversion regulations in March 1974. The new rules rejected the "free-distribution-of-stock" method of conversion and provided for the sale of conversion stock. Depositors would be given the first opportunity to purchase shares in amounts proportionate to their deposit balances as of a record date; with any shares not purchased by the depositors made available for purchase by the institution's management and the public. The value of the new

stock to be issued would have to equal the fair market value of the converted savings association, determined in accordance with procedures that would be established by the FHLBB.

The FHLBB's March 1974 sale-of-stock approach to conversions was criticized by some, due to concern over the prospect of windfall profits accruing to a converting association's management and other insiders. As a result of those concerns, Congress extended the statutory moratorium against conversions until June 30, 1976.

In June 1980 the Fourth Circuit Court of Appeals upheld the FHLBB's authority to approve federal mutual to stock conversions and concluded that the FHLBB's regulations appropriately protected the rights of mutual members.

As extensively amended by the FHLBB in 1986, the current OTS conversion regulations are extremely detailed and complex. In general they require sale of the converting institution's stock at a price equal to its estimated <u>pro forma</u> market value, with priority to subscribe being given to existing mutual accountholders. Aggregate purchases by insiders are limited to 25% to 35% depending on the institution's size, although Employee Stock Option Plans (ESOP's) may acquire an additional 10%. Generally, no person acting in concert with any associate or group of persons may purchase more than 5% of the conversion

stock. With certain exceptions, insiders must hold stock purchased for one year, and the converted institution may repurchase up to 5% of its conversion stock every six months after the conversion. The rules apply to conversions of both federal and state savings associations. While OTS consent is required before any conversion may take place, OTS may waive any requirement of the regulation for good cause shown. Consequently, it is our understanding that any individual conversion involves extensive specialized negotiation with OTS and will depend both on the regulation and an extensive body of precedent, policy and case-by-case analysis.

Comparison of OTS and State Rules on Mutual to Stock Conversions

The OTS regulations on mutual to stock conversions, which are essentially those of the old FHLBB, are comprehensive and detailed. They cover all the major aspects of conversions, including insider transactions, repurchase limits, standards applicable to management benefits and recognition, employee stock option plans, the priority scheme for depositor purchases, valuation of the converting institution and requirements for adequate public disclosure of the proposed conversion transaction to depositors and potential investors. In addition to the detailed regulations, the OTS has developed an expertise in regulating and monitoring mutual to stock conversions. The OTS staff's role often requires interpretations of the conversion

rules that go beyond the issues specifically addressed in the regulations. The OTS regulations give the agency a great deal of discretion and a specialized segment of lawyers and appraisers has grown up to deal in this area of government regulation.

State laws and rules regarding mutual to stock conversions of state-chartered savings banks are generally not as comprehensive as the OTS rules. Even those states where savings banks have a long tradition may not have as detailed and encompassing conversion regulations as the OTS. The rules of some states we looked at closely, however, are similar to the OTS mutual to stock conversion rules with explicit provisions to safeguard the rights of depositors and potential investors. Like the OTS rules, these states' rules also impose limits on the amount of stock the insiders of the converting institution may acquire.

Attachment 1 provides a side-by-side comparison of certain of the OTS rules on mutual to stock conversions with the rules of five selected states.[1] As indicated, state rules vary widely in scope. For example, the rules of New York, Massachusetts and Illinois may be considered similar in scope and breadth to the OTS regulations, although, the OTS rules are more detailed and encompassing. North Carolina's rules address many of the same

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[1] The FDIC did not undertake a review of all the states' laws and rules on mutual to stock conversions of savings banks.

issues as the OTS, but in the area of insider purchase limits, for example, the North Carolina rules impose a 5% limit per director but no express limit on the aggregate of insider purchases. The OTS rules limit aggregate insider purchases to 25% to 35% of the offering of conversion stock. Wisconsin's current rules make no provision for insider limits, but new Wisconsin rules which will become effective later this year are expected to address this and other areas of mutual to stock conversions of savings banks chartered by that state. In addition, while the New York and Massachusetts rules, for example, impose limits on "insider" purchases similar to those of the OTS, they do not impose specific limits on stock purchases by employee stock option plans and management recognition plans. The OTS rules include such limitations.

The FDIC has not done an in-depth study of all recent mutual to stock conversion transactions. In fact, one main objective of our proposed policy is to obtain more nationwide information about this activity. For example, with respect to two recent conversions in New York State, it appears that the results of the transactions (particularly in the area of insider benefits) would have been substantially the same had the transaction been subject to OTS conversion rules instead of New York's conversion regulations.

Preliminarily, the FDIC has observed that the mutual to stock conversion rules are most comprehensive and encompassing at the Federal level. The nature and scope of the OTS regulations may or may not, in general, better safeguard the rights and interests of depositors and investors involved in conversion transactions than states' rules. Some states' conversion rules may be adequate in safeguarding the rights of depositors and potential investors in such transactions, and also in protecting against uncalled for gains by institution insiders. During the comment period for the proposed policy statement, the FDIC will continue to study the situation surrounding mutual to stock conversions of state-chartered savings banks, with a special eye toward any safety-and soundness concerns that may be present. The question remains whether the Federal public policy interest in fairness to depositors is so great as to over-ride the variations of state law with a more comprehensive Federal set of rules.

FDIC's Authority to Regulate Conversions

The OTS has specific statutory authority and responsibility in 12 U.S.C. 1464(i)(2)(A) to regulate mutual to stock conversions of savings associations. The FDIC has no such express statutory authority to regulate such conversions by state savings banks under its primary jurisdiction. Our authority to regulate and supervise such conversion transactions is dependent

on our general ability to articulate reasonable concerns about actions that could jeopardize the safety and soundness of converting institutions. Documentation of significant past abuses could help to establish a basis for such a rulemaking. Such a regulation would have to be drafted to specifically address the safety and soundness risks which FDIC may perceive to be inherent in the type of transaction and which are not being adequately dealt with by applicable State laws. Merely to establish uniform Federal standards for such conversions may not, in and of itself, be an adequate basis for embarking upon a new regulatory effort, absent a specific statutory authority to do so.

Section 39 of the Federal Deposit Insurance Act ("FDI Act") may be a potential source of authority for the FDIC to oversee some aspects of mutual to stock conversions by those state savings banks under FDIC's primary jurisdiction. Section 39, which was added by section 132 of FDICIA, provides that excessive compensation, or compensation that could lead to a material financial loss for an institution, is an unsafe and unsound practice. Section 39 directs the agencies to promulgate regulations prescribing standards specifying when compensation is excessive. Proposed regulations are now out for public comment. Section 39 of the FDI Act could potentially be utilized to prevent certain inappropriate payments to insiders in mutual to stock conversions.

Finally, we should not lose sight of the fact that for every conversion acquisition that results in a mutual savings bank being acquired by another financial institution, the regulator of the acquiror or the Federal Reserve would have approval authority under the Bank Merger Act or the Bank Holding Company Act.

FDIC's Proposed Statement of Policy on Mutual to Stock Conversions

The FDIC is not without extensive experience in supervision of mutual institutions converting to stock form. In the 1980's many FDIC-supervised savings banks in New England, New York and elsewhere converted under provisions of state law. There was little concern for the conversion process itself. However, supervisory issues arose later when converted institutions stretched their investment and credit standards in an attempt to profitably employ the new capital and produce a rapid return for the new investors. Our prompt corrective action and rapid growth rules should give us the tools to monitor and prevent this post-conversion behavior in the future.

The FDIC Board on January 24, 1994 approved issuance of a forty-five day request for comment on all aspects of the mutual to stock conversion subject. Attachment 2 of this testimony is our proposed policy statement. FDIC staff has been working on this proposal since early last year.

In brief, the proposed policy statement focuses on areas of potential abuse in conversion transactions -- pricing the shares, apportioning the stock subscription rights, and disclosure of information needed to make an informed investment decision. We are asking for comment on whether or not state oversight is sufficiently uniform and adequate across states to protect the interests of the public, or whether Federal oversight is necessary; whether abusive practices are prevalent or likely and whether and why the FDIC should take action; and whether the proposed policy statement contains enough specificity to be effective in providing worthwhile guidance. Comments are also requested as to whether mutual to stock conversions should be governed by an enforceable regulation, and if so, should such a regulation closely follow the existing regulation of the OTS that contains a large degree of specificity, or should it more closely resemble a guidance format as embodied in the proposed policy statement. We are also very aware that reduction of unnecessary regulatory burden is an important matter of current concern.

Public comment is considered important in this case because of questions regarding jurisdiction, regulatory burden, the need for FDIC intervention, uncertainty regarding the usefulness of a policy statement, and the growing public and legislative interest in mutual conversion transactions. The knowledge we may gain from testimony before this Subcommittee, and from the public comment letters we will receive, should enable us to more

effectively respond to all facets of the mutual to stock conversion issue. We will be pleased to share all comment letters, as we receive them, with the Subcommittee and OTS.

FDIC Views on Proposed Legislation

The proposed legislation, H.R. 3615, entitled the "Mutual Bank Conversion Act", would require the FDIC to write regulations similar to those that govern stock conversions under OTS rules. Adopting such regulations would bring uniformity to the conversion process and eliminate, to the extent it exists, any motive to change charters before converting from mutual status. However, we are uncertain at this time whether it is necessary to have identical rules for all converting institutions, particularly if the FDIC's proposed policy statement is adopted. The Federal Reserve Board and Securities Exchange Commission already review these transactions. In addition, the new capital that is injected into the converting institutions improves safety and soundness. We also note that some of the transactions, considered by some to be overly generous to insiders under state jurisdiction, nevertheless do generally conform to OTS rules.

We believe that the proposed legislation, if eventually deemed necessary, should be modified. One course might be to grant the FDIC the flexibility and authority to adopt its own regulations consisting, in part, of the existing OTS and state

rules on conversions. If Federal regulatory uniformity is considered the preferred course, our recommendation is that the FDIC and OTS jointly write new regulations that would build on the OTS experience, yet be less cumbersome and burdensome to the industry. Particular care should be taken to balance concerns over the possibility of unjust insider enrichment against the potential for discouraging conversions, especially of marginally capitalized or undercapitalized mutuals, where conversion is in the best interest of the deposit insurance funds.

H.R. 3615 contains a provision making it retroactive to last November. We understand that this has had the desired effect of slowing down, but not completely stopping, conversion transactions. The uncertainty caused by this potential retroactivity means that we owe it to the public to resolve quickly the question of whether there will be Federal action. We stand ready to work with the Congress in forming the answers.

Attachment 1

COMPARISON OF OTS AND SELECTED STATES' MUTUAL-TO-STOCK CONVERSION RULES

	OTS	North Carolina	Wisconsin (Current)	Wisconsin (Effective in Merch or April 1994)	New York	Messachusetts	Illinois
1. Insider Purchase Limits	Aggregate purchases by officers, directors and non-tax qualified employee stock benefit plans limited to 25% to 35% of offering, depending on size of converting association.	Individual purchases by members of the board of directors are limited to 5% of the offering. No provision is made for aggregation of insider purchases.	No provision is made for insider limits.	Officers and directors (and their associates) may purchase up to an aggregate of 35% of the offered shares.	Aggregate purchases by directors, officers and executive officers shall not exceed 25% of the stock issued by the converting institution.	Aggregate purchases by officers, trustees, corporators & directors of the converting bank (and their associates) shall not exceed 30% of the total offering.	No limits on purchases by officers; directors' subscription rights limited to 20% of offering. Aggregation with non-tax qualified stock benefit plans not expressly provided for.
2. Stock Benefit Plans							
a. ESOPs	Tax-qualified employee stock benefit plans (primarily ESOPs) may purchase up to 10% of conversion offering.	Tax-qualified ESOPs may purchase up to 10% of the conversion offering.	No provision is made regarding ESOPs.	No specific provision is made regarding ESOPs.	No specific provision is made regarding ESOPs.	No specific provision is made regarding ESOPs.	Employee stock benefit plans may purchase up to 15% of conversion offering.

COMPARISON OF OTS AND SELECTED STATES' MUTUAL-TO-STOCK CONVERSION RULES

	OTS	North Carolina	Wisconsin (Current)	Wisconsin (Effective in March or April 1994)	New York	Massachusetts	Illinois
b. MRPs	As a matter of policy, non-tax qualified employee stock benefit plans (primarily management recognition plans) may purchase up to 3% or 4% of conversion offering, depending on capitalization.	Non-tax qualified ESOPs may purchase up to 5% of the conversion offering.	No provision is made regarding MRPs.	No specific provision is made regarding MRPs.	No specific provision is made regarding MRPs.	No specific provision is made regarding MRPs.	MRPs may purchase up to 5% of conversion offering.
c ESOPs & MRPs	As a matter of policy, ESOPs & MRPs combined may purchase up to 12% of conversion offering depending on capitalization	Aggregation of ESOP & MRP purchases not expressly provided for.	Aggregation of ESOP & MRP purchases not expressly provided for.	No specific provision is made for ESOPs end MRPs.	No provision is made for ESOPs & MRPs.	No provision is made for ESOPs & MRPs.	Aggregation of ESOPs & MRPs purchases not expressly provided for.

COMPARISON OF OTS AND SELECTED STATES' MUTUAL-TO-STOCK CONVERSION RULES

	OTS	North Carolina	Wisconsin (Current)	Wisconsin (Effective in March or April 1994)	New York	Massachusetts	Illinois
3. Over-Subscription	Insiders and employees purchase at the same priority as account-holders.	Insiders & employees purchase at the same priority as account-holders.	No provision is made for oversubscription.	Shares shall be allocated among subscribing eligible account-holders to permit each to purchase 100 shares, if possible.	Each eligible account holder shall be entitled to total shares proportional to the value of his or her account.	Shares shall be allocated among subscribing eligible account-holders to permit each to purchase 100 shares, if possible.	Insiders and employees who have been account holders for 5 years prior to the conversion receive priority in the allocation of over-subscribed stock.
4. Under-Subscription	Subscribers in the next lower category may purchase stock. Remainder to be sold at public offering.	Subscribers in the next lower category may purchase stock. Reminder to be sold at public offering.	No express provision made for under-subscription. Reminder to be sold at public offering.	Shares sold as provided for in the plan of conversion.	Shares not sold to depositors with subscription rights shall be sold in a public offering.	Shares not sold in the subscription offering shall be sold in a public offering.	Insiders end employees may receive subscription rights to purchase unallocated shares of conversion stock.

COMPARISON OF OTS AND SELECTED STATES' MUTUAL-TO-STOCK CONVERSION RULES

	OTS	North Carolina	Wisconsin (Current)	Wisconsin (Effective in March or April 1994)	New York	Massachusetts	Illinois
5. Insider Holding Period	Insiders who purchase stock in the conversion offering must hold the stock at least one year before selling, with exceptions.	Insiders who purchase stock in the conversion must hold the stock for at least one year before selling, with exceptions.	No express provision made for insider holding periods.	Insiders who purchase stock in the conversion offering must hold the stock for at least one year after the date of purchase, with exceptions.	Insiders who purchase stock in the conversion offering must hold the stock for at least one year before selling, with exceptions.	Insiders who purchase stock in the conversion offering must hold the stock for at least one year after the date of purchase, with exceptions.	Directors who purchase conversion stock must hold it for one to five years, as determined by the savings bank. Officers must hold the stock for one year, with exceptions.
6. Qualifying	The minimum account balance for "eligible account-holder" status may be no higher than $50.	The minimum account balance for "eligible account-holders" may not be higher than $50.	No express provision made for minimum deposit.	The plan of conversion may provide that accounts with a balance of less than $500 is not a qualifying deposit for voting purposes.	The minimum account balance for eligible account holders cannot exceed $100.	The plan of conversion may provide that depositors with balances of less than $50 are not "eligible account holders."	The minimum account balance for "eligible account-holder" status may be no higher than $1,000.

COMPARISON OF OTS AND SELECTED STATES' MUTUAL-TO-STOCK CONVERSION RULES

	OTS	North Carolina	Wisconsin (Current)	Wisconsin (Effective in March or April 1994)	New York	Massachusetts	Illinois
7. Stock Repurchase	A converted institution may repurchase up to 5% of its conversion stock in any 6-month period following the conversion.	No provision is made for repurchase of stock by the converted association.	No express provision is made for stock repurchase by the association.	Stock repurchases by the converted institution is prohibited for 3 years, with exceptions.	No converted institution shall repurchase any shares of its common stock without the prior provision of the superintendent of banks.	No express provision is made for stock repurchase by the converted bank.	A converted savings bank may repurchase up to 10% of its conversion stock in any 6-month period following the conversion.
8. Required Vote	A plan of conversion must be approved by a majority of the votes eligible to be cast at the special meeting of members.	A plan of conversion must be approved by a majority of eligible member votes.	A plan of conversion must be approved by a majority of the member votes.	A plan of conversion must be approved by a majority of total outstanding votes.	A plan of conversion must be approved by a vote of seventy-five percent in amount of deposits (or book value of outstanding shares).	A plan of conversion must be approved by a vote of two-thirds of all "corporators" present and voting at a special meeting.	A plan of conversion must be approved by a vote of at least two-thirds of the total outstanding votes.

COMPARISON OF OTS AND SELECTED STATES' MUTUAL-TO-STOCK CONVERSION RULES

	OTS	North Carolina	Wisconsin (Current)	Wisconsin (Effective in March or April 1994)	New York	Massachusetts	Illinois
9 Price Range	Conversion stock must be sold within a range that varies no more than 15% above or below a midpoint estimate of the association's pro forma market value.	Conversion stock must be sold at its pro forma market valuation.	Conversion stock must be sold pursuant to an independent valuation of the association.	Stocks must be priced based on an independent valuation.	Conversion stock must be sold at a price equal to the estimated pro forma market value of such stock.	Converting bank shall issue and send its capital stock at a total price equal to the estimated pro forma market value of such stock based on an independent valuation.	Conversion stock must be sold at the association's estimated pro rata market value.

Attachment 2

FEDERAL DEPOSIT INSURANCE CORPORATION

Proposed Statement of Policy on Mutual to Stock Conversions

AGENCY: Federal Deposit Insurance Corporation (FDIC)

ACTION: Notice of Proposed Policy Statement

SUMMARY: The FDIC solicits comments on a Proposed Policy Statement setting forth guidance with respect to the conversion from mutual to stock ownership of State chartered savings banks and the FDIC's supervisory concerns on the matter.

DATES: Comments must be received by [insert date 45 days after date of publication].

ADDRESSES: Send comments to Executive Secretary, FDIC, 550 17th Street, NW, Washington, DC 20429. Comments may be hand delivered to room F-400, 1776 F Street NW, Washington, DC on business days between 8:30 a.m. and 5:00 p.m. [Fax number (202) 898-3038]. Comments will be available for inspection and photocopying in room 7118, 550 17th Street, NW, Washington, DC between 9:00 a.m. and 4:30 p.m. on business days.

FOR FURTHER INFORMATION CONTACT: Robert F. Miailovich, Associate Director (202-898-6918), Garfield Gimber III, Examination Specialist (202-898-6913), Division of Supervision, or Walter P. Doyle, Counsel (202-898-3682), Legal Division, FDIC, 550 17th

Street, NW, Washington, DC 20429.

REQUEST FOR PUBLIC COMMENT: The FDIC is considering adoption of a policy statement on conversion from mutual to stock form of ownership. Comment is requested on all aspects of the subject and, in particular, the proposed policy statement.

All state authorities provide some degree of oversight over mutual to stock conversion transactions involving institutions under their jurisdiction, and a number of statutes exist that deal with securities disclosure and changes of management and/or control and acquisitions. With respect to state oversight, comment is requested on whether or not such oversight is sufficiently uniform and adequate across states to protect the interests of the public, or whether federal oversight is necessary.

In light of existing federal and state securities laws and state conversion laws, comment is requested on what abusive practices are prevalent or likely and whether and why the FDIC should take action. If so, should the focus of FDIC attention be on the long-standing accountholders/members or are other interests, such as those of borrowers, trustees, management and employees, also important?

Comment is requested on whether the following proposed policy statement contains enough specificity to be effective in providing

worthwhile guidance and preventing potentially objectionable practices. If the proposed or even a strengthened policy statement providing guidance to the industry is not considered adequate, should mutual to stock conversions be governed by an enforceable regulation? If so, should such a regulation closely follow the existing regulation of the Office of Thrift Supervision on this subject, with specific percentage limitations, such as on insider investments, or should a regulation more closely resemble a guidance format as embodied in the proposed policy statement? Should the FDIC seek or support Congressional action in this matter?

PROPOSED STATEMENT OF POLICY ON MUTUAL TO STOCK CONVERSIONS BY STATE CHARTERED BANKS

I. Background

In recent years a number of state chartered mutual savings banks have converted to stockholder owned state savings banks. Many of these institutions first converted from federally chartered mutual savings associations to state chartered savings banks. In some cases, the conversion results in an acquisition by or merger into another institution, with accountholders/members obtaining stock in the acquiring institution and not the converting savings bank.

One consequence of these conversions to state charter is that the FDIC may replace the Office of Thrift Supervision as the primary

federal regulator. The mutual to stock conversion process is then subject to the rules and protections of state law. The Office of Thrift Supervision regulations governing conversions from mutual to stock form were enacted in 1974 in reaction to instances of abusive conversion transactions wherein insiders and their interests captured a large share of the converting institution's capital stock for considerably less than fair market value. The Office of Thrift Supervision regulation was structured to protect the interest of the converting mutual's accountholders/members in the current equity and perceived future value of the institution against abusive insiders and opportunistic depositors.

II. Reasons for FDIC Policy

Conversion rules under state law are not identical to and may be less stringent than Office of Thrift Supervision regulations. Absent effective state laws or some federal oversight over state mutual savings banks converting to capital stock form, the opportunity for inconsistency and abuse is ever present.

The areas of particular concern for potential abuse in conversion include: (1) Pricing the shares, (2) Apportioning the stock subscription rights, and (3) Disclosure of information needed to make an informed investment decision.

Offering the shares at too low of a price may unjustly enrich the recipients, increase the temptation by insiders to acquire more

shares than they are fairly entitled to, and deny the institution all of the additional capital it should receive to protect depositors and the insurance fund. Setting the share price too high may result in poor investment decisions by accountholders/ members that may lack investment expertise.

In some conversion transactions insiders may appear to have received preferential treatment over the interests of accountholders/members who have supported the mutual savings bank. Management and directors, it can be argued, should not be preempted from receiving a fair portion of the stock rights since they have contributed to the value of the institution and should properly be induced to remain with the institution. However, management and directors also will continue to receive salaries and fees for their services to the institution.

In addition, mutual savings banks that convert to stock form undertake a major restructuring that possibly can lead to significant changes in the nature or volume of business conducted. In the past, some institutions, in leveraging capital raised through a conversion and reaching for a return on equity, have vigorously competed for loans and liberalized underwriting standards which led to loan losses that in many instances depleted more capital than was raised through conversion. Because of this potential, the FDIC feels the need to know at an early date the institution's business plan for post-conversion operation, growth

and investment of any newly injected capital.

III. Statement of Policy

State chartered mutual savings banks converting to capital stock ownership should afford adequate protection to the interests of long-standing accountholders/members in the current equity and perceived future value of the institution against insiders and opportunistic depositors. Such protection should include: (1) Correctly pricing the shares, (2) Equitably apportioning the stock subscription rights, and (3) Adequately and timely disclosing all relevant and pertinent information needed to make an informed investment decision.

A thorough independent appraisal by a qualified appraiser is appropriate in order to establish and justify a fair offering price for the shares of stock in the converted institution. The appraisal should include consideration of earnings projections, future prospects for a rate of return including any new capital, other recent stock offerings and conversion transactions, and the historic and current relationship of market price to book value and price/earnings ratio for nearby and similar sized institutions.

Accountholders/members who have supported the mutual savings bank over some reasonable period should be given considerable deference in the apportionment of stock subscription rights. Management and directors who are accountholders/members are entitled to the same

rights as non-insider accountholders/ members. Any additional deference accorded to insiders, including employment contracts and other benefits in an acquisition or merger into another institution, should be only as part of an adequate compensation program and thus be limited, justified and documented. Apportioning that leads to individual windfall gains should be avoided. Directors are reminded of their duty of loyalty to the converting institution.

The holders of stock subscription rights should be adequately and timely notified of their rights to buy. Offering the shares through a firm that is independent of the converting institution's insiders and their interests is one way to help insure that this takes place. Full disclosure of all relevant information should be made. Accountholders/members should be able to easily use funds on deposit to fund their purchases. In addition, accountholders/ members should be fully informed of the risk inherent in purchasing stock. If stock sales are conducted on the institution's premises, care should be exercised to make sure accountholders/members clearly understand that stock purchases are not deposits and are not insured by FDIC.

State chartered mutual savings banks that contemplate converting to stock form are requested to notify the FDIC region in which the head office is located at an early date and submit for comment all the relevant terms and conditions, financial information and

documents inherent in the conversion, including a business plan for post-conversion operation, growth and investment of any newly injected capital. The FDIC will work closely with the State authority in preparing any comments.

The FDIC review of transactions or a case-by-case basis will include consideration of whether the directors and management of the institution have fairly and effectively discharged their fiduciary duties of due care and loyalty to the institution and its accountholders/ members.

Should the FDIC determine that the proposed conversion may raise safety and soundness concerns, or otherwise subject the bank to substantial legal liability, it may request additional information from the bank and/or may seek appropriate modifications in the terms and conditions of the proposal to alleviate those concerns. In situations where abusive insider self-dealing, fraud or other violations are suspected, stronger enforcement measures may be considered.

Depending on the terms and outcome of the transaction, the conversion may require formal federal approval under the Bank Holding Company Act or the Bank Merger Act, or appropriate notice under the Change in Bank Control Act.

Conversions to stock form, involving undercapitalized institutions,

at the direction or control of a regulatory authority are sometimes called "supervisory conversions". This FDIC statement applies equally to such conversions.

By order of the Board of Directors. Dated at Washington, D.C. this ____________ day of __________, 1994.

FEDERAL DEPOSIT INSURANCE CORPORATION

____

Executive Secretary

(SEAL)

RESOLUTION

WHEREAS, a number of Federal mutual savings associations have converted to state savings bank charter and then from mutual to stock ownership, thereby avoiding restrictions on mutual to stock conversions imposed under Office of Thrift Supervision regulations;

WHEREAS, the Board of Directors is considering whether to adopt a policy statement that would apprise institutions converting to stock ownership at the State level of certain general supervisory guidelines and safety and soundness considerations that FDIC considers it appropriate to follow in such conversions, or whether some other regulatory course of action should be considered;

NOW THEREFORE BE IT RESOLVED, that the Board of Directors hereby approves publication of the attached proposed policy statement on this subject, for 45 days public comment, and directs the Executive Secretary to cause such statement to be published in the _Federal Register_, with such editorial modifications as the Executive Secretary considers appropriate.

Tommy G. Thompson
Governor

Harold N. Lee, Jr.
Commissioner

J. David Christenson
Deputy Commissioner

State of Wisconsin

Office of the Commissioner of Savings and Loan

4785 Hayes Road, Suite 202 • Madison, Wisconsin 53704-7365 • (608) 242-2180 • FAX# (608) 242-2187

COMMENTS OF HAROLD N. LEE, JR.
WISCONSIN SAVINGS AND LOAN COMMISSIONER

TO THE
U.S. HOUSE OF REPRESENTATIVES
Subcommittee on Financial Institutions
Supervision, Regulation and Deposit Insurance
of the
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

Regarding

MUTUAL TO STOCK CONVERSION
IN THE THRIFT INDUSTRY
AND
H.R. 3615

JANUARY 26, 1994

Mr. Chairman, Committee Members:

My name is Harold Lee and I am the savings and loan commissioner for the state of Wisconsin. I have been with the commissioner's office for 26 years and Wisconsin's record speaks for itself. We have experienced only one state chartered failure and that could have been resolved if the FDIC hadn't taken over. The average tangible capital of our state chartered institutions exceeds 12% of assets and there are no serious problems.

I want to thank the Committee for providing this opportunity for the state regulators to give you our perspective on the mutual to stock conversion process in today's market.

With prodding from some federal regulators and Washington attorneys, state regulatory systems have been accused in the print media of providing far more lucrative insider benefits in the state conversion process than those that are available under policies of the Office of Thrift Supervision. In most cases, ladies and gentlemen, that is just not true. Most of the stories have centered on merger/conversions in North Carolina with some more recent articles on regular conversions in the midwest. Hearings were conducted in North Carolina last week and we can move on to the regular conversion process in other parts of the country.

I think it might help you to understand what has happened if we step back to 1989 and FIRREA. This Act established the Office of Thrift Supervision as the primary federal regulatory for state thrift institutions along with the savings association insurance fund for the FDIC. For the state systems, the result was an unfair financial burden of supporting three regulators, the FDIC, OTS and the state chartering agency. This meant that the state chartered thrift institutions were the only financial institutions in the country regulated by and having to financially support three regulatory agencies.

In looking for ways to relieve this financial burden the American Council of State Savings Supervisors turned to the savings bank concept and developed model legislation. That model has been used as the basis for state legislation in several states, including Wisconsin. Many of the institutions in these states have now converted to savings banks but not to get a better deal in the conversion process as state system opponents claim.

In Wisconsin we have had 24 conversions from savings and loans to savings banks. Of those only 2 were federally chartered institutions. Three mutual savings banks have now converted to stock form and I anticipate a few more, but the majority of those 24 institutions will continue to operate as mutual institutions. Savings and loan associations continue to move to the savings bank structure to escape the cost and frustration of the second federal regulator, not to get a fat deal from the state regulator in a mutual to stock conversion.

To give you a little background, we need only go back to 1980 and the first mutual to stock conversion in Wisconsin. There were only a handful of additional conversions over the next several years until 1990 when the market started to move. In the past two years we have had 14

mutual to stock conversions at the state and federal level. Eleven under OTS policy and three under state rules and regulations. The most infamous in Wisconsin is the recent conversion of Security Bank, S.S.B. in Milwaukee on December 30, 1993.

The public offering was $270 million. Under state jurisdiction, 7% of the offering was used for the Employee Stock Option Plan (ESOP) and 5% for Management Recognition Plans (MRP). Although only 3.96% of the MRP was awarded. A 3% management set aside was established to assure management of a reasonable purchase level. Management purchases totalled 7% after allocation reductions at the depositor level. Insider benefits in this transaction are within the policies of OTS as demonstrated by the Astoria Federal conversion in New York with an ESOP at 9.9% and the MRP at 5%.

Security Bank has a 1 rating in safety and soundness; a 1 rating in compliance and a CRA rating of outstanding. This is one of the best operated thrift institutions in the nation. Would it be fair to this institution, for me as a state regulator, to provide less insider benefits than provided under OTS policy, just because they are a state chartered institution. Think about it for a minute.

In Wisconsin the terms of all conversions of state mutual thrifts are controlled by my office on an individual basis and provide insider benefits very similar to the policy limits of OTS. We have, however, encouraged the use of a management set aside as a part of the transaction. Setting aside a small portion of the offering to insure that management has the opportunity to purchase a reasonable amount of stock is very realistic from the regulatory perspective. If the management group have their own funds at risk they will be prudent in their management responsibilities. Also consider that all management purchases during conversion must be held for at least one year. How many stock offerings do you think would be sold out if all the purchasers had to hold their stock for a year? I don't believe there would be any.

We have also used geographical limitations in determining priorities for stock purchasers to insure that the long-term, faithful customers of our Wisconsin institutions have the ability to purchase stock in their institution. This was not used in the Security conversion to assure broad distribution and the result is approximately 12,000 stockholders of that institution.

Employee stock option plans are generally the institution's retirement program and seem to be acceptable to most. Management recognition or retention plans on the other hand are being questioned as gift to management and the directors. These plans or awards are a product of the federal system and were encouraged as an enticement for mutual institution management to go through the stock conversion process to bring additional capital into the system. The thrift industry is much healthier now but in some areas of the country, weak capital positions are still a concern. Mutual to stock conversion is still being heavily promoted at the federal level.

Management incentive plans have become a tool to recognize management's contribution over the years, but even more important to maintain continuity of management after the conversion. Benefits or awards are generally paid out over a three to five year period. This insures that management will be in place to carry out the business plan established during the conversion

process and that is extremely important to the ongoing operation of an institution flush with new capital.

As you can start to see from this, it is not the state systems that are the problem. It is the implementation of policies developed under the federal system, especially when applied to large offerings. Even a 1 or 2% MRP in a $270 million offering is a significant amount of money. Again, at the federal level the 5% MRP at Astoria Federal amounted to $16.5 million under OTS policy.

In Wisconsin we have experimented with the use of federal policies in our first three conversions and have already started to make adjustments. It is difficult when the institutions can switch to a federal charter and convert under OTS policy. We have had 4 conversions from state to federal charter in the last two years. It is time to take a good look a benefit policies and make some changes. Current OTS policies worked well for several years but under current market conditions may be too lucrative, especially for very large transactions.

It would make sense for the FDIC to adopt guidelines covering all mutual to stock conversions in the thrift industry. They will need the authority to step in whenever a state or federal regulator allows benefits significantly outside of their guidelines. This will do away with most of the competition between state and federal agencies but allow for some innovation and flexibility in the system. We, as state regulators, would be more than happy to work with the FDIC in developing some reasonable guidelines that protect states rights and still provides the Congress with the comfort they are looking for.

As I see it, H.R. 3615 as proposed is an irresponsible attempt to override states rights and impose rules on the nation that don't work now. I believe it has been promoted by OTS and it is apparent to me that there has been no input from state thrift regulators or their National Organization. H.R. 3615 is a step backward for the dual system. We all know that all of the innovation in financial services comes from the state systems. If you shut the door on that innovation and eventually federalize the regulation of financial services providers you will seriously damage our banking system in America.

TESTIMONY

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS,
SUPERVISION, REGULATION AND DEPOSIT INSURANCE

of the

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

U.S. HOUSE OF REPRESENTATIVES

by

WILLIAM J. DRUMM, SUPERINTENDENT

DIVISION OF SAVINGS & LOAN ASSOCIATIONS

AND

DIVISION OF SAVINGS BANKS

STATE OF OHIO

on

H.R. 3615, THE MUTUAL BANK CONVERSION ACT

JANUARY 26, 1994

Mr. Chairman and Members of the Committee:

My name is William J. Drumm. I am the Superintendent for both Savings & Loan Associations and Savings Banks for the State of Ohio. Thank you for the opportunity to testify before you today.

BACKGROUND INFORMATION

Ohio's savings and loan industry has traditionally been a strong competitive force within our state and is so regarded within the nation.

As Superintendent, I am the primary regulator for both state-chartered savings and loan associations and savings banks in Ohio. As of December 31, 1993, there were 85 state-chartered savings and loans, and 19 state-chartered savings banks in Ohio. The combined assets of these institutions approximates $14.5 billion. I am pleased to report that our institutions are basically in good financial condition, and that, out of 104 institutions, only seven institutions are rated 3 or below on either the MACRO or CAMEL rating system.

In 1991, the savings bank charter, as defined in Chapter 1161. of the Ohio Revised Code, was created in Ohio. The savings bank charter provides a new option for existing thrifts and commercial banks in Ohio, as well as for de novo charters. To date, 19 savings and loan associations, both state and federally chartered, have converted to state-chartered savings banks. At the present time, an application for a de novo savings bank charter is pending as are three additional charter conversions. Furthermore, of the 19 savings banks, ten are stock companies and nine are mutual companies.

INCREASING CAPITAL REQUIREMENTS AND THE SAVINGS BANK CHARTER

The recent trend in converting savings and loan associations to savings banks was inevitable. Continuing changes in federal laws and regulations have mandated that overall capital levels in thrift companies be increased. In order to meet this mandate, management of these associations was required to look for ways to control expenses, increase income, and thus increase capital.

Mutual companies were automatically placed at a disadvantage. There is no mechanism whereby capital markets can be accessed by mutual companies to bolster their capital position. Their only source of additional capital is through cost control and increased earnings. Most often management has to shrink the company, thus decreasing funds available for customer borrowing and enhancing the perceived credit crunch.

The best option available to mutual companies is the ability to convert to a stock company. This provides the vehicle to access capital markets to increase capital as necessary. These conversions provide flexibility in meeting the capital needs of a company based upon both the actual performance of the company and changing regulatory capital requirements.

Unfortunately, during the savings and loan crisis, stock in savings and loans was not particularly attractive. In order to sell stock in the converted company, management had to consider moving away from the savings and loan name and converting to savings banks. Savings banks have had no such stigma attached to them. They can provide increased lending and earnings potential due to a reduced qualified thrift lender test (QTL), and only have one federal regulator--the Federal Deposit Insurance Corporation (FDIC). Thus, the savings bank charter has become the only viable option for many companies.

SAVINGS BANK REGULATION

In Ohio, savings banks are subject to supervision and regulation by the Division of Savings Banks. Supervision of a converted savings and loan association is not diminished as a result of the conversion. With the exception of changes in lending authorities and the QTL test, a savings bank in Ohio is subject to statutes and regulations that parallel those of the savings and loan associations. Additionally, a common examination staff is utilized by both divisions, which ensures regulatory continuity for the converted institution.

The Federal Deposit Insurance Corporation serves as the federal agency responsible for ensuring that all the requirements of federal laws and regulations are met. There is no reduction in meeting the requirements of federal law. However, the converted institution is more efficiently regulated since only one federal agency is involved.

I believe that it is necessary to make a personal observation as to the role of the federal agencies. I have served as a managing officer for several thrift associations in Ohio. The Office of Thrift Supervision (OTS) has the reputation of micromanaging thrift institutions. In particular, the Cincinnati Office of the FHLBB, predecessor to the OTS, has carried this to extremes. Since assuming my current position, I have found that the Cincinnati Office was not consistent with the OTS in general. While recent changes within the OTS are a marked improvement, in Ohio the OTS has a major stigma attached to it and its ability to effectively fulfill its responsibilities. The FDIC, on the other hand, has a good reputation as being a firm but fair regulator.

MUTUAL OWNERSHIP OF SAVINGS BANKS

The Division of Savings Banks holds to the traditional belief that depositors of mutual savings banks, aka members, are the owners of that company. As such, they are entitled to elect the officers and directors of the company; to determine what the company's articles of incorporation, constitution and bylaws are; and to determine what changes to the company's corporate structure should be, i.e., acquisitions, conversions, or mergers.

Unfortunately, the individual depositors/members of a mutual savings bank often are not aware of these responsibilities and do not actively participate in the affairs of their company. This is due, in part, to the common practice of their executing a blanket proxy for management at the time they open a deposit account. From that point on, management has the authority to

take whatever actions are necessary to operate the company. The individual depositors/members can revoke their proxies at any meeting, but our experience shows that this rarely happens. Their inactivity leaves the overall operation of the company in the hands of the directorate and management.

It is necessary to put things in perspective, however. The individual depositors/members of a mutual savings bank have not been harmed by the current system. They earned interest on their deposit accounts and had the opportunity to borrow from their company. As a federally insured institution, their deposits were protected up to the limits established by the Savings Association Insurance Fund (SAIF). Additionally, as the net worth of the company grew, they were guaranteed a share of the profits in the event of its total liquidation.

MUTUAL TO STOCK CONVERSION ACTIVITY

Section 1161.111 of the Ohio Revised Code provides for the conversion of mutually owned savings banks to stock savings banks. In preparation for such conversions, Rule 1301:12-1-08, "Conversion from Mutual to Stock Form of Ownership", was promulgated and became effective concurrent with Chapter 1161. This rule basically established the procedural requirements for such conversions.

Ohio's first and only application for conversion from a mutual savings bank to a stock savings bank was received during the third quarter of 1993. This application involved the conversion of Heritage Savings Bank, Cincinnati, Ohio, and the simultaneous acquisition of the stock by Provident Bancorp., Cincinnati, Ohio. This transaction has been the subject of articles in both *The American Banker* and *The Wall Street Journal*. Unfortunately, these articles have not been totally accurate.

In preparation for this application, the applicants were advised that the Division would basically adhere to OTS regulations and guidelines relating to the conversion of a mutual thrift company to a stock thrift company and that the Division would require full disclosures of the transaction to Heritage's members in order for them to vote upon the plan of conversion. The applicants were advised, however, that the Division would be flexible in applying OTS standards provided any deviations from existing standards were fully supported.

In evaluating a mutual to stock conversion, the division considers the following:

- All options available are fully disclosed to the depositors/members;
- A fair market value is established for the savings bank by means of an independent appraisal;
- All facets of the transaction, including benefits to the directors, officers and employees, are adequately disclosed to the depositors/members;

- The depositors/members' subscription rights are not diminished as a result of the benefits to the directors, officers and employees;
- No unreasonable benefits accrue to either the directors or management;
- The company can afford the transaction and any corresponding benefits for its directors, officers and employees;
- The transaction will not negatively impact upon the overall safety and soundness of the converted company; and
- New revocable proxies are solicited from each depositor/ member.

Provided that all of these concerns have been addressed, the application is conditionally approved subject to action by the depositors/members.

Upon thorough evaluation of the Heritage transaction, we determined that each of these concerns was adequately addressed.

SUMMARY DISCUSSION

Based upon Ohio's experiences, the proposed statute and mandatory rule-making is overkill and would tend to ignore the overall record of supervision of the respective states. It is recognized that mutual to stock conversions are currently taking place at an accelerated pace. The motive of Ohio's mutuals is primarily to provide more flexibility in meeting net worth requirements without the forced sale or takeover of the institution. A window of opportunity exists as a result of recent earnings performance which enhances a company's ability to raise capital (i.e., sell stock). However, I believe this window may be short lived.

I believe that undue attention has been focused upon mutual savings banks as opposed to mutual savings and loans. In Ohio, mutual savings and loan associations are not converting to state chartered savings banks merely to avoid federal oversight or to provide significant benefits to directors, officers and employees at the expense of the depositors/members.

Too much reliance is being placed upon OTS regulations and guidelines. Of particular concern are OTS requirements that individual depositors/members subscription rights are subordinate to the subscription rights of both tax qualified employee stock benefit plans and non-tax qualified employee stock benefit plans.

Ohio's sole application by a mutual savings bank to convert to a stock savings bank provided all depositors/members full access to the projected pro forma value of the converted

savings bank based upon an independent valuation or appraisal. Any additional compensation or benefits were provided by the acquiring holding company or from restricted holding company stock accounts and were on par with the benefits provided to all other directors, officers, and employees of the holding company.

In closing, I believe that it is appropriate to restate those areas which should be considered in a mutual to stock conversion:

- All options available are fully disclosed to the depositors/members;
- A fair market value is established for the savings bank by means of an independent appraisal;
- All facets of the transaction, including benefits to the directors, officers and employees, are adequately disclosed to the depositors/members;
- The depositors/members' subscription rights are not diminished as a result of the benefits to the directors, officers and employees;
- No unreasonable benefits accrue to either the directors or management;
- The company can afford the transaction and any corresponding benefits for its directors, officers and employees;
- The transaction will not negatively impact upon the overall safety and soundness of the converted company; and
- New revocable proxies are solicited from each depositor/ member.

By keeping these items in proper perspective, we, as regulators, can ensure that the transaction is fair to all depositors/members, is in the best interest of the company, and that the depositors/members have good information on which to base their decisions.

As the Committee's actions have put mutual to stock conversions up in the air, I urge the Committee to resolve this issue as soon as possible so that those companies needing access to capital can take advantage of the existing window of opportunity.

I appreciate the opportunity to present my views to you today. I would be happy to answer any questions you have at the appropriate time.

ATTACHMENT #1

OHIO REVISED CODE

1161.111 Conversion to stock form

A savings bank without permanent stock may convert itself to the stock form, subject to the rules of the superintendent of savings banks. The superintendent shall adopt rules governing such conversions, but prior to the adoption of the rules, a savings bank without stock may convert to the permanent stock form with the prior approval of the superintendent.

HISTORY: 1991 H 397, eff. 10-23-91

PRACTICE AND STUDY AIDS

Baldwin's Ohio Legislative Service, 1991 Laws of Ohio, H 397—LSC Analysis, p 5-425

CROSS REFERENCES

Conversion from mutual to stock form of ownership, OAC 1301:12-1-08

ATTACHMENT #2

Ohio Administrative Code

1301:12-1-08 Conversion from mutual to stock form of ownership

(A) In order to convert from a mutual to a permanent stock form of ownership, a savings bank must file an application in accordance with this rule and receive prior written approval thereof from the superintendent.

(B) The application for conversion shall include:

(1) A plan of conversion;

(2) Amendments to the savings bank's articles of incorporation and a check payable to the secretary of state for the applicable filing fee;

(3) Amendments to the savings bank's institution and bylaws;

(4) A copy of the proxy and soliciting materials to be used; and

(5) Other information as the superintendent may require.

(C) The plan of conversion shall provide:

(1) A comprehensive description of the nontransferable subscription rights received by each eligible accountholder, including details on oversubscriptions;

(2) That the shares of the converting savings bank be offered to persons with subscription rights and management, in that order, and that any remaining shares shall be sold either in a public offering through an underwriter or directly by the converting savings bank in a direct community offering;

(3) That a direct community offering by the converting savings bank shall give a preference to natural persons residing in the counties in which the savings bank has an office;

(4) That the sale price of the shares of capital stock to be sold in the conversion shall be a uniform price determined in accordance with paragraph (I) of this rule, and shall specify the underwriting and/or other marketing arrangements to be made;

(5) That the conversion must be completed within twenty-four months from the date the savings bank members approve the plan of conversion;

(6) That each savings accountholder of the converting savings bank shall receive, without payment, a withdrawable savings account or accounts in the converted savings bank equal in withdrawable amount to the withdrawal value of such accountholder's savings account or accounts in the converting savings bank;

(7) For an eligibility record date;

(8) That the expenses incurred in the conversion shall be reasonable;

(9) That the converting savings bank shall not loan funds or otherwise extend credit to any person to purchase the capital stock of the savings bank;

(10) That the proxies held with respect to voting rights in the savings bank will not be voted regarding the conversion, and that new proxies will be solicited for voting on the proposed plan of conversion;

(11) The amount of the deposit of an accountholder shall be the total of the deposit balances in the accountholder's savings accounts in the converting savings bank as of the close of business on the eligibility record date. The plan of conversion may provide that total deposit balances of less than fifty dollars (or any lesser amounts) shall not be considered for purposes of paragraph (C)(6) of this rule; and

(12) That for a period of one year after the date of the conversion, no converted savings bank shall repurchase any of its capital stock if the effect thereof would cause the savings bank to not meet its capital requirements.

(D) A plan of conversion shall be adopted by not less than two-thirds of the savings bank's board of directors.

(E) Upon determining that an application for conversion is properly executed and is not materially incomplete, the superintendent will advise the savings bank, in writing, to publish a notice of the filing of the application. Promptly after receipt of the advice, the savings bank shall prominently post the notice in each of its offices and publish the notice in a newspaper printed in the English language and having general circulation in each community in which an office of the savings bank is located, as follows:

Notice of filing of an application for permission to convert to a stock savings bank

Notice is hereby given that, pursuant to section 1161.111 of the Revised Code ________ has filed an application with the Ohio division of savings banks requesting approval to convert to an Ohio-chartered permanent stock savings bank. The proposed plan of conversion will be available for inspection by any member of the savings bank at the offices of the division of savings banks in Columbus, Ohio, and at each office of the savings bank. Materials supporting the objections from any member of the savings bank or aggrieved person will be considered by the division of savings banks if filed within ten business days after the date of this notice.

(F) Promptly after publication of the notice or notices prescribed in paragraph (E) of this rule, the savings bank shall file one copy of the notice together with an affidavit of publication from each publisher with the superintendent.

(G) Following approval of the application for conversion by the superintendent, the plan of conversion shall be submitted to the members at an annual or special meeting and the plan shall be approved, in person or by proxy, by at least a majority of the total outstanding votes of the members of the savings bank.

(H) No offer to sell securities of a savings bank pursuant to a plan of conversion may be made prior to superintendent approval of the:

(1) Application for conversion;

(2) Proxy statement; and

(3) Offering circular.

(I) If the offering is to commence prior to the meeting of the savings bank members held to vote on the plan of conversion, the proxy statement and preliminary offering circular authorized for use by the superintendent shall set forth the estimated price range.

(1) The maximum of such price range should normally be no more than fifty dollars per share or fifteen per cent above the average of the minimum and maximum of such price range.

(2) The minimum of such price range should normally be no less than five dollars per share or no more than fifteen per cent below such average.

(3) No representation may be made in any manner that the superintendent has approved such price information.

(J) Within forty-five days:

(1) Of the date of the mailing of the subscription form, the subscription rights must be exercised.

(2) After the last day of the subscription period, the sale of all shares of capital stock of the converting savings bank to be made under the plan of conversion, including any sale in a public offering or direct community marketing, shall be completed.

(K) The converting savings bank shall pay interest at not less than the passbook rate on all amounts paid in cash or by check or money order to the savings bank to purchase shares of capital stock in the subscription offering or direct community offering from the date payment is received by the savings bank until the conversion is completed or terminated.

(L) For the purpose of this rule:

(1) The public offering shall be deemed to commence upon the filing with the superintendent of the preliminary offering circular for the public offering; and

(2) The direct community offering shall be deemed to commence upon the declaration of effectiveness by the superintendent of the final offering circular.

(M) The superintendent may grant a written waiver from any requirement of this rule.

(N) For purposes of this rule:

(1) The term "control" means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

(2) The term "person" includes an individual, a group acting in concert, a corporation, a partnership, a savings bank, a trust, any unincorporated organization, or a government or political subdivision thereof.

HISTORY: Eff. 11-17-91 (1991-92 OMR 526)

CROSS REFERENCES

RC 1161.111, Conversion to stock form
RC 1163.24, Rulemaking powers

ATTACHMENT #3

Ohio Department of Commerce

George V. Voinovich, Governor

Division of Savings & Loans/Savings Banks
77 S. High St. • 21st Floor • Columbus, OH 43266-0512
(614) 466-3723 • FAX (614) 466-5594

Nancy S. Chiles, Director

November 18, 1993

Jack R. Wingate, Executive Vice President
Heritage Savings Bank
3316 Glenmore Avenue
Cincinnati, Ohio 45211

Leslie C. Nomeland, Senior Counsel
Provident Bancorp, Inc.
One East Fourth Street
Cincinnati, Ohio 45202

Gentlemen:

Pursuant to sections 1161.11 and 1161.78 of the Ohio Revised Code, the applications for Heritage Savings Bank (Heritage) to convert from a mutually organized savings bank to a permanent stock savings bank and to be simultaneously acquired by Provident Bancorp, Inc., (Bancorp) are hereby approved subject to the following conditions:

1. The conversion and acquisition shall conform in all material respects to the representations made by Heritage and Bancorp in the documentation submitted to the Division in the applications.

2. The Plan of Conversion shall be approved in person or by proxy by at least a majority of the total outstanding votes of the members of the savings bank.

3. In the event that Heritage is no longer deemed "well capitalized" as defined in 12 CFR 325.103(b)(1), or as such section may be hereafter amended, Bancorp shall immediately supplement Heritage's capital such that Heritage shall be deemed "well capitalized."

4. The establishment and maintenance of the liquidation account(s) corresponding to Heritage's existing retained earnings shall be accounted for in accordance with the Federal Financial Institution Examination Council's Instructions for Preparation

Jack R. Wingate, Executive Vice President
Leslie C. Nomeland, Senior Counsel
Page Two
November 18, 1993

of Reports of Condition and Income, as amended, and Generally Accepted Accounting Principles. Heritage shall submit the accounting with appropriate explanation and footnotes to the Division for review and approval within 14 business days after consummation of the transaction.

5. Heritage shall submit copies of the approvals of the appropriate federal agencies to the Division.

6. Heritage shall submit, on Division forms, originally executed Articles of Incorporation, Constitution, and Bylaws to the Division.

7. Heritage shall submit copies of the minutes of the members' meeting and the report of the inspectors of the election to the Division.

8. In the event that the subscription offering is undersubscribed, Bancorp will contribute capital in addition to the net proceeds of the subscription offering up to the total appraised value of Heritage minus any discount on the subscription shares sold and expenses incurred.

9. Within thirty business days after consummation of the transaction, Bancorp shall provide the Division, in tabular form, a list of all eligible subscribers and their respective subscription requests. In conjunction with the foregoing list, Bancorp will submit to the Division, a list of all new Bancorp shareholders arising from the offering.

Should you have any questions regarding this approval, please feel free to contact the Division.

Yours very truly,

William J. Drumm

William J. Drumm, Superintendent
Division of Savings Banks

WJD:jlb:rly

cc: Federal Reserve Bank of Cleveland
Federal Deposit Insurance Corporation

Consumer Federation of America

STATEMENT OF CHRIS LEWIS
DIRECTOR OF BANKING AND HOUSING POLICY
CONSUMER FEDERATION OF AMERICA
ON
INSIDER ABUSE IN MUTUAL BANK CONVERSIONS
BEFORE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS,
SUPERVISION, REGULATION AND DEPOSIT INSURANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

HONORABLE STEPHEN L. NEAL
CHAIRMAN
JANUARY 26, 1994

The Consumer Federation of America appreciates the opportunity to testify before the Subcommittee on insider abuse in the conversion of mutual banks to stock-owned financial institutions and on H.R. 3615, the Mutual Bank Conversion Act.

The Banking Committee can take justifiable pride in the work it performed in 1989 to reform the regulation of the savings and loan industry and put and end to the high-flying schemes that drained deposit insurance funds and the U.S. Treasury.

But the job is not complete.

One area of abuse -- the conversion of mutual institutions into stock companies -- was left untouched by the reforms and this oversight -- however accidental -- has turned into a wonderful, fur-lined play pen for S&L insiders, conversion law firms and stock manipulating Wall Street fast-buck artists. And, once again, it is the depositor-consumer who is left out in the cold.

Today's road to riches for S&L insiders is a simple legal two-step. First, to get out from under Federal scrutiny of a mutual conversion, management swops a Federal mutual savings and loan charter for a State charter. Then, under liberal State rules, the Board of Directors expropriates the built-up equity of the mutual association in a stock offering or advertises their availability to be bought out, i.e., paid off, by an acquiring institution.

Most, if not all, of this activity is perfectly legal because

1424 16th Street. N.W., Suite 604 • Washington, D.C. 20036 • (202) 387-6121

Congress, the state legislatures and their various regulatory agencies have failed to adequately deal with the problem -- and have left a mish-mash of weak and conflicting rules on the books that have provided a welcome mat for the sharp deal makers. Fair play has often gone out the window in this massive "Conversion Lotto" with all the odds -- and the winnings -- in favor of the insider.

As the chief executive of one Federal savings institution has said: "We are in the middle of a feeding frenzy".

The Office of Thrift Supervision (OTS), under Acting Director Jonathan Fiechter, does deserve credit for leaping into the jaws of this feeding frenzy. The staff has tracked the developments state by state and has drafted regulations to try to control the worst abuses.

A good try, but not enough. OTS needs help in the form of statutory across the board safeguards that will protect the depositors -- the real owners -- in these mutuals and the safety and soundness of the financial system -- and prevent unfair, unearned windfalls from lining the pockets of the insiders. Unfortunately, many of the states and apparently OTS's sister agency -- the Federal Deposit Insurance Corporation (FDIC) -- as one trade public noted last year appear "unfazed" by the concerns.

Some regard the issue as a "turf war" between the OTS and the FDIC -- with the converted state savings banks added to the jurisdiction of the FDIC -- and subtracted from the universe of institutions under the wing of the OTS. Turf wars being what they are in this town, there is undoubtedly a lot of truth in these assumptions.

But, we believe that the Congress should look past the bland assurances from the FDIC and not dismiss the OTS concerns out of hand. Turf wars aside, any casual glance at the financial landscape should be enough to alert this Committee and the Congress to the fact that the rules of the conversion road are sadly deficient and horribly inconsistent from state to state.

CONVERSION HISTORY

True, there have long been conversions from mutual ownership to stock ownership. But, from the post-World War period to the mid-1970s the number of conversions were infinitesimal -- not even a blip on the regulatory radar scheme.

But conversions began to grow and in 1974 -- in a rare moment of regulatory and Congressional foresight -- conversion regulations were adopted with the emphasis placed on preventing "windfalls" in the conversion of a mutual thrift -- windfalls that might create "irresistible pressures" on other mutuals to convert and, more

importantly, windfalls that led to abuses by insiders to the detriment of the mutual share holders.

Again in 1976 and 1979 -- in response to concern about stock manipulation and insider abuse -- the regulations were broadened. Then in 1982 -- as the era of deregulation dawned -- "flexibility" was added to conversion regulations and holding company and merger conversions were authorized.

POST-FIRREA WINDFALLS

Today much of the concern centers around these merger conversions and it is this activity that has spawned the headlines about "feeding frenzies" and resulting abuses.

We identify four principle areas of abuse or potential for abuse are evident on the conversion battlefield:

1. Insiders obtaining control of institutions through conversions;

2. Unfair and excessive "deals" offered "insiders" to induce officers and directors to push for conversions without regard to the best interests of depositors or the community;

3. Fraudulent low appraisals of institutions involved in the transactions, letting holding companies obtain mutuals at bargain basement prices; and,

4. Limitation of meaningful participation of account holders -- the real owners -- in the transactions.

There is also concern that the "big deals" and the stories of lucrative pay-offs to officers and directors -- as well as discounted stock arrangements for depositors -- will ultimately create that "irresistible urge" for other mutuals to leap into the game.

This Committee needs to look carefully at whether these artificially-induced urges are really good public policy or the right way to build a financial system -- where the publicly-backed insurance funds is involved. Hopefully, the experience of the 1980's has taught us that unrestrained greed at insured financial institutions can lead not only to an expensive bill to the taxpayers but to the creation of an unstable and unsustainable financial system.

While OTS and FDIC feud about the issues, there are voices on the outside that have expressed concerns. An newsletter, the Thrift Regulator, quoted a Washington lawyer and conversion expert recently as warning:

"There are some states where management can buy so much stock before the depositors get in that the equity and fairness in the conversion process goes away."

Whether regulators and Federal and State governments look on these issues as good, bad, or indifferent, no one can ignore the fact that something big has been going on in the conversion arena. Since FIRREA, scores of institutions have swopped Federal for State charters, almost 300 mutuals have converted to stock companies and the average amount of stock sold per conversion has increased from $10 million in 1989 to some $32 million in 1993.

Underneath these numbers are case-histories that more dramatically point to the problems being generated by these merger conversions.

Let us remember that the owners of record of these institutions are the depositors -- that is the definition of a mutual -- of cooperative ownership.

But to watch these schemes in action, you would never recognize that fact. Perhaps no one says it better than Home Savings depositor Evelyn Surratt who testified before the Committee last week:

"I don't think the officers and directors are doing right by us members. It looks to me like they're looking out for themselves instead of us. They should treat the people right who stuck by them all these years, but their not. The statute book says we're the owners. I've seen it. It's plain. Anybody can understand it. I'll read it to you, "Members are the owners of a mutual savings bank." But they've got all these high-powered experts trying to tell us the law doesn't mean what it says. That's just not right. A lot of folks in Albermarle might not have a whole lot of education, but we're smart enough to know right from wrong."

Clearly, what the owners -- the depositors -- are getting in many of these conversions is nothing more than the crumbs from the table. Sitting at the big feast on the inside are the directors and officers who are wooed to grease the skids for the quick slide into stock companies or holding company acquisition.

Provident Bancorp's President, Allen Davis, who has been scouring the Midwest in search of mutuals willing to play the merger-conversion game is very blunt about why the Cincinnati Ohio-based holding company likes the game.

"We can virtually get the institution for relatively nominal amounts."

And the numbers published in the American Banker last November indicate that Mr. Davis is, indeed, the master of understatement.

The American Banker estimated that Provident would be paying roughly $1.573 million to officers and depositors of Heritage Savings, an Ohio mutual with an appraised value of nearly $5.7 million -- a more than three-fold windfall. From Ohio, to North Carolina, to Wisconsin to Florida these self-enrichment schemes abound.

In the polite worlds of banking, finance and the stock market, the lucrative deals offered insiders are described as necessary "inducements" and proper payments to those that have "managed the institutions so well". Among the less polite and less sophisticated these look like just plain old bribes used to let someone -- some corporate entity -- make off with the goods while everyone looks the other way.

And one wild deal begets another wild deal. The disease spreads and ultimately the pressures become difficult to resist and merger-conversions start moving whether or not it is the true desires of the management or the depositors. And deals move under theses pressures even when there are serious questions about what the schemes may mean to financial stability -- and the safety of deposit insurance funds.

HOW MANY HANDS IN THE COOKIE JAR?

Not only has the conversion mania created a new and aggressive breed of insiders, but it has spawned a sophisticated team of "outsiders" who roam the country opening accounts at mutual institutions in the hopes of cashing in on lucrative stock deals offered at discount prices in a conversion.

The New York Times says some of these operators have opened hundreds of accounts as a "relatively inexpensive way to get stock at low prices."

Apparently, this band of "sophisticated outsiders" has sometimes created situations where depositors' demand for stock far outstripped the banks' ability to satisfy it.

At Home Savings Bank in Hollywood, FL, depositors and management submitted orders for $105 million of stock in late 1992, but the company was issuing only $24 million. Some of the requests for stock were in the form of buy orders for lots of a half million dollars each.

"An awful lot of people from New York City somehow found out and made deposits so they could buy the stock," an executive of the institution was quoted as saying.

INADEQUATE DISCLOSURE

True, depositors, sifting through the crumbs on the table, do

get rights to buy stock also -- and in many cases this can be lucrative. But, lucrative is a relative term and while the depositor is playing in the nickel-and-dime end of the market, the merger-conversion schemes are letting big time operators make off with million-dollar fortunes. Depositors, in effect, get "hush money" so the corporate executives and their lawyers can work quietly on the big end of the deals.

One principal area of concern for CFA is the poor and often misleading disclosure given to mutual depositors of a proposed conversion to a stock company. Depositors are both misinformed by management about the nature and consequences of a conversion and provided woefully inadequate time and resources to respond to management recommendations for conversion.

The simple fact is that depositors are at an overwhelming disadvantage to appreciate the significance of and to respond to proxy statements that are written in incomprehensible legalize and often delivered in junk mail packaging.

But, as the Committee heard last week in the case of CCB Financial Corporation's purchase of Shelby Savings and Loan, simple and clear disclosure does work. Many of the depositors -- the steady customers who have kept their mutual institution alive during good and bad times -- don't necessarily want to cede control of their institution.

RECOMMENDATIONS ON H.R. 3615

The Mutual Bank Conversion Act, H.R. 3615, takes an important first step to curb the raging wildfires of greed that have been set in many states through the passage of liberal conversion statutes. The bill would provide for parity between Federal and State rules governing the conversion of mutual associations. This would end the perverse incentives currently at play in the market place for management to compromise their fiduciary obligations to mutual depositors. H.R. 3615 should be passed -- if only to prevent a larger forest fire of greed from taking hold.

But, in its current form, it is not enough.

H.R. 3615 does nothing to correct the weaknesses in current Federal conversion rules. Real safeguards for fair play in the distribution of proceeds must be firmly established in statute.

The simply fact is that even under OTS rules management can walk away with enormous unearned windfalls. Our analysis is that under OTS rules insiders can obtain up to 57% of the stock of a converting mutual.

Call it what you will, but CFA can find no public policy rationale for insiders having any advantage over the depositor-

owners of mutual institutions undergoing a conversion to a stock company. We recommend that the bill be amended to prohibit any preference for insiders in a mutual conversion. This will create positive incentives in the marketplace for conversions to be maximally structured to protect depositor rights.

Secondly, as has been pointed out by other witnesses, mutual insiders are often able to manipulate the voting on a conversion through the exercise of previously executed general proxies. We believe that the bill should include a prohibition on the exercise of general proxies for any conversion -- i.e, only fresh proxies may be used to approve a conversion. A conversion is a death sentence for a mutual and every precaution should be taken to make certain that members willingly agree to shoot their own horse.

Lastly, we recommend that the bill include a mandate for a thorough General Accounting Office audit of the conversion process. The Committee needs to bring its full resources to the table to monitor this activity. Specific areas of focus for the GAO should include management compensation; low-balled appraisals; and, the adequacy of notice to depositors of a proposal for conversion.

Beyond the strict subject of today's hearing -- insider conflicts of interest in mutual conversions -- CFA has general concerns about the loss of mutual institutions from the financial services marketplace. When organized effectively with depositor participation, mutual associations provide for a broad-based form of financial ownership, accountability to depositors and therefore to local communities.

However, mutual institutions have suffered greatly over the years by managers who have inadequately informed an association's members about their institution and by a Federal and State regulatory environment that has been critical -- in word and deed -- of the mutual form of organization.

The Committee can do much to correct these trends and help revitalize mutual associations. Policies should be adopted to encourage and nurture mutual institutions. Mutually-owned institutions should not disappear from the financial scene in these high-flying schemes. Regulators should take steps to push mutuals toward true "depositor owned and controlled" institutions, not just collectors of proxies.

CONCLUSION

While the conversion issue may not be the biggest regulatory problem to come before this Committee, it is clearly a prime exhibit for those pushing for a rational consolidation and coordination of regulatory policy and enforcement.

Not only do we have questions about conversions, but we have

an exhibition of world-class leap-frogging between Federal regulatory agencies -- and a budding feud that only confuses the regulatory issues.

One agency -- OTS -- sounds fire alarms about conversions while its sister agency -- the FDIC -- yawns and says don't worry we have plenty of fire trucks and fire fighters. And the agencies issue their pronouncements from separate marble palaces sitting right next to one another around the corner from the White House.

And then we have the States, some of which have added their own regulations to the mix -- and some allowing what Forbes Magazine described as "bonanzas" for management and other insiders.

Congress needs to clean up this mess now -- while there are still some mutuals left to serve local communities. The conversion game has been going on full tilt and if remedial action is delayed, the issue will be relegated to the graveyard of good ideas that Congress let die on the vine. For the depositor-owner ripped off while the insiders trotted off to the islands with the goods, next year is too late.

STATEMENT

of

DAVID E. A. CARSON
CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER
PEOPLE'S BANK

on behalf of

SAVINGS & COMMUNITY BANKERS OF AMERICA

before the

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND DEPOSIT INSURANCE

HOUSE OF REPRESENTATIVES

January 26, 1994

Mr. Chairman, Members of the Subcommittee, my name is David Carson. I appreciate the opportunity to appear today on behalf of Savings & Community Bankers of America, of which I am First Vice Chairman, to testify regarding H.R. 3615, the Mutual Bank Conversion Act, which you, Chairman Gonzalez and Ranking Minority Member Leach introduced on November 22, 1993.

By way of background, I am the Chairman, President & CEO of People's Bank, a $6.4 billion savings bank located in Bridgeport, Connecticut. People's is organized as a mutual holding company, a corporate format we adopted in 1988 in accordance with the law of our chartering authority, the State of Connecticut. The conversion was consistent with the current rules in this area of the Office of Thrift Supervision. Our institution is insured by the Bank Insurance Fund of the Federal Deposit Insurance Corporation and the FDIC is our primary federal regulator.

H.R. 3615 would specify that state chartered mutual savings banks not regulated by the OTS would be required, should they elect to convert to the stock form, to do so in accordance with regulations of the FDIC "substantially similar" to those of the OTS. Although the FDIC has begun the process of rulemaking in this area, it currently has no regulations governing mutual-to-stock conversions, leaving such alterations in corporate status entirely to state law (although once the conversion occurs, the Corporation becomes the institution's

primary securities regulator). Our understanding is that the bill, which would be effective retroactive to its introduction date, is designed in large measure to ensure that treatment of depositors and institution insiders by converting companies tracks the OTS standard.

SCBA does not at this time believe that a problem exists in the conversion area that cannot be cured through appropriate action by the FDIC. SCBA on two occasions has urged the FDIC to issue curative rules. Because of the retroactive nature of H.R. 3615, until the FDIC so acts, a serious cloud will continue to hang over the whole area of non-OTS-regulated conversions, with even companies that willingly would convert under OTS-type rules being fearful of proceeding. This is a regrettable and costly state of affairs.

Consequently, we were greatly encouraged that the FDIC on January 24, 1994, issued a proposed policy statement regarding mutual-to-stock conversions by state savings banks under its jurisdiction. The statement proposed that converting institutions should afford such protections as correct pricing of shares, equitable apportionment of stock subscription rights, and adequate and timely disclosure of all relevant and pertinent information needed to make an informed investment decision. It also specifically asked for comment on whether the FDIC should adopt an enforceable regulation governing mutual-to-stock conversions closely following the existing regulations of the OTS.

Our willingness to answer this question in the affirmative stems from the fact that the conversion framework developed by the OTS is one that has served affected savings institutions, their members and their communities very well for almost twenty years. It was developed in the light of considerable Congressional interest and scrutiny and has been

upheld by the courts as consistent with depositor rights. It has been used to convert some 1,030 mutual institutions to stock form, bringing those companies some $16 billion in outside capital.

These funds have served as a major systemic shock absorber against losses and protection for the taxpayers in addition to enabling companies prudently to expand the banking services they provide their communities. Let me stress that such benefits have flowed as well from the billions of dollars in capital raised in the numerous conversions by savings banks occurring over the years outside OTS jurisdiction under applicable state law.

SCBA thus regards the availability of a stable, effective, legal framework for conversions as a goal of the utmost importance. At present some 1,240 savings institutions with some $ 231 billion in assets are in the mutual form. Mutual institutions have proved over the years to be conservative, community-oriented companies that, because of their form of organization, are well able to adopt a long-range approach to their businesses. At present, they have lower non-interest expense ratios than their stock peers (2.30% versus 2.50%), higher tier-one capital (17.71% against 12.44%), and a better return on assets (0.84% versus 0.68%). Clearly, they will continue to be an important and vital presence in the financial system.

Nevertheless, mutuals essentially are able to raise capital only through earnings, and, if one thing is clear in the aftermath of FIRREA and FDICIA, it is that Congress has decreed that, for depository institutions, "capital is king." The ready access to additional capital offered by conversion to the stock form thus is an essential option for mutual companies seeking

outside funds to protect against losses and to permit prudent expansion of operations to better serve their communities with home and other lending and deposit services.

Notwithstanding the very real benefits which the OTS approach to conversion has offered over the years, it has been subject to some criticism as being insufficiently generous to depositors. Making the incorrect assumption that depositors are owners of a mutual institution in the sense that shareholders are owners of a stock institution, it has been suggested that conversions should result simply in distributing stock to depositors, instead of giving them rights to purchase shares in the initial public offering.

The Federal Home Loan Bank Board, the OTS' predecessor agency, long ago rejected this approach as misconstruing the rights of depositors, who are in actuality creditors to whom applicable law may accord a varying role in corporate governance and rights to receive any surplus in the event of a liquidation. To make depositors recipients, through free distribution of stock, of the market value of converting institutions would be to provide them with an unbargained for windfall for which they have undertaken absolutely no risk, and would add nothing to the capital position of the company. The Bank Board also was concerned that the availability of such windfalls would have a disruptive and destabilizing effect on the entire mutual segment of the industry.

The FHLBB correctly determined that, from a public policy standpoint, the primary objective of the conversion process should be to produce a stronger depository better positioned to provide the home lending and other community banking services it was chartered to deliver, making equitable provision for those depositors wishing to become shareholders to participate

on a priority basis in the initial public offering, and for all depositors' liquidation rights. As noted, the regulatory framework devised by the FHLBB has been uniformly upheld by reviewing courts.

Earlier in my remarks, I noted that SCBA has asked the FDIC to issue conversion rules. Specifically, we have proposed that the FDIC, rather than preempt state law entirely in this area, undertake an examination of state law regimes and permit those that are substantially similar to the OTS standard to continue in force. If a state framework met the standards, conversions could proceed under the state aegis. Otherwise, they would have to be processed by the FDIC under its regulations. This would be less intrusive than a total preemption, leaving room for accommodation to legitimate variations in practice desired by state legislators and regulators.

As we noted earlier, the retroactive nature of H.R. 3615 has had a disruptive and confusing effect on the conversion process. Generally, retroactive legislation, in our view, is an undesirable method of proceeding, and typically raises questions under the Constitution's injunction against ex post facto law. At a minimum, we would urge the authors of H.R. 3615 to clarify publicly that savings bank conversions may go forward provided OTS standards are observed with regard to depositor stock purchase rights, appraisal, insider benefits and so forth, regardless of whether they and proceeding under an FDIC regulatory framework. In addition, we strongly urge you to publicly endorse a practical and equitable approach to grandfathering transactions that were substantially underway as of November 22, 1993; approval by an institution's board of a plan of conversion would be a reasonable benchmark. .

As a final matter, Mr. Chairman, I wish to comment on the current trend toward conversion by OTS-regulated savings associations to savings banks subject to the primary federal jurisdiction of the FDIC. Some 186 such conversions have occurred since enactment of FIRREA.

The dominant impulse behind this trend often has been mischaracterized -- first, as a desire to obtain broader investment authority, and, currently, as only reflecting an interest in converting to stock form under state rules more liberal than those of the OTS. The liberal investment hypothesis is disproved by the fact that when federal regulators lifted the moratorium on such conversions after limiting converted companies to exercising only the same powers they enjoyed under OTS rules, a very large number of companies nevertheless exercised that option. While I suspect some companies have converted to take advantage of state mutual-to-stock regulations, there have been too many exits by stock savings institutions and by institutions in states that utilize the OTS framework, such as Illinois, to assume that this has been a dominant objective. SCBA is convinced that the primary objective is to escape OTS examination costs and the annual assessment levied by OTS on its regulatees to pay for its operations; for a $100 million institution, the assessment would amount to about $16,000, and examinations are considerably more costly. As you know, many commercial banks over the years similarly have avoided national bank charters and accompanying examination fees and assessments by the Office of the Comptroller of the Currency.

Mr. Chairman, this concludes my prepared remarks, and I will be happy to answer any questions you may have.

STATEMENT OF WILLIAM KOSTIW

DEPOSITOR OF THE GREEN POINT SAVINGS BANK

Mr. Chairman, thank you for inviting me to speak today. My name is William Kostiw and I am from Flushing, New York. I am here with my counsel, Martin Lowy. I and many other depositors of The Green Point Savings Bank have opposed the conversion transaction that the trustees proposed and we are pleased to have this opportunity to tell you about it.

We also are pleased that Republic New York Corporation has funded our efforts since without funding, depositors' opposition is ineffective.

The conversion proposal had three things wrong with it:

Number 1: It didn't allocate enough to depositors. We have evaluations that show that the bank is worth over $1 billion <u>before the conversion</u>. The proposed transaction only allocated $50 million to depositors -- and to get that they have to meet special future conditions.

Number 2: The trustees, officers and employees arrogated too much for themselves. The non-officer trustees (who work at most a couple of days a month) admitted they were taking over $20 million. Our experts say they would have made over $50 million -- for just 12 people, several of whom have been there three years or less.

Number 3: The appraisal of the bank is absurdly low. As I said, we have evaluations of over $1 billion <u>without more capital</u>. The total valuation given by Green Point's appraisers is $700 million after almost that amount of new capital. This underappraisal makes no sense.

Now you have asked me what we are doing about it. Some other depositors have brought a class action in Federal court. I am not one of the named plaintiffs in that case. I have joined with a group that has petitioned the New York State Superintendent of

Banks to permit us to intervene in the secret hearings that he has been holding. We have asked him to set aside the proposed conversion.

I must say that we have been disappointed that Superintendent Cephas did not permit us to intervene and made nothing public. Therefore we brought a proceeding in the New York courts to force him to let us intervene and to review his action.

As you know, we have been partially successful in that the Superintendent has set aside the trustees' and officers' excessive compensation. We applaud that action. He has not, in our view, however, made the right conclusion about the appraisal or about how the trustees' original motives taint the transaction or about the proxy solicitation. We therefore have asked the court to enjoin the Superintendent from issuing a stock charter to Green Point.

You also have asked whether H.R. 3615 adequately addresses our concerns.

Quite frankly, it does not. Again for three reasons:

Number 1: I am informed that FDIC oversight might ameliorate the trustee compensation problem. But it would not cure the problem and instead it would put the FDIC in the position of policeman with no stated law to enforce. I do not think that replacing the length of the State Banking Superintendent's foot with the length of some FDIC staffer's foot is a significant improvement. In the Green Point case the Superintendent has used his foot correctly on the compensation issue, but we do not know whether that will extend to other cases.

Number 2: I also am informed that the federal regime does not enforce the market value appraisal requirement very much better than the state regimes do. The Federal regulations are supposed to

set an example using the highest ethical and moral standards. Something stronger is needed because no one in the process has an incentive to comply with the law's requirement of a true market value appraisal.

Number 3: H.R. 3615 would not give depositors any access to the surplus when overcapitalized mutuals convert. Sharing in the surplus is at the heart of what we think would be a fair system.

Our proposal is that the trustees be permitted to allocate to depositors any part of the surplus that is deemed to be in excess of the amount prudently required to operate the bank. This surplus could go to all depositors over the last six years in accordance with their average deposits, with interest compounded, using the tax records on interest earned as the benchmark.

I say use the tax records because all banks have them in machine readable form, and therefore the computation of each depositor's shares of the total allocated to depositors would be very easy to compute.

The mechanism will detract little from the new stockholders' value and will give value to the depositors, who are the closest thing to owners of the surplus.

In the alternative, stock could be substituted for cash after the foregoing computations.

Mr. Chairman, we are not against progress. But we are against insiders taking all the money for themselves and we think that we, the ordinary depositors, deserve more than the proposed Green Point conversion offers us.

Thank you.

MUTUAL BANK CONVERSIONS

By Jonathan R. Macey

Americans often react with smug pity to stories of Russia's continued problems transferring property rights to the private sector. Yet many of these Americans may themselves be victims of poorly defined property rights and a failure to adhere to basic principles of the rule of law--as depositors in Green Point Savings Bank, one of the thousands of mutually owned banks and savings associations in the U.S., have learned in recent months.

In theory, mutuals are owned by their depositors. But the "property rights" associated with this ownership are notoriously ill-defined. Doing business in mutual form represents all costs and no benefits.

Several decades ago, depositors in mutual institutions bargained away their rights to share in the corporate profits in exchange for certain other benefits that no longer exist. While in the past they often could receive loans on favored terms, vigorous competition in the financial services industry has eliminated this advantage. And federally sponsored deposit insurance has made depositors indifferent to the riskiness of their financial institutions, eliminating the benefits of depositing in an institution with no outside owner.

HOW TO PROFIT

Yet mutuals live on. To all intents and purposes owned by no one, they are managed by self-perpetuating boards of trustees who nominate and elect themselves. Deposit insurance, combined with

the lack of outside equity investors, insulates them from competition not only in the capital markets but in the market for corporate control. And, not surprisingly, the managers, like their Russian cousins, will fight vigorously before giving up the security and privileges of their positions.

Much as the Soviet-era bureaucracy has been quick to take advantage of the new era, management of mutuals, with the complicity of regulators, has in recent years discovered an even better way to profit from their sinecures. By converting their institutions to the stock from of ownership, and granting themselves generous stock and option awards, trustees and managers can make millions of dollars in the conversion. While the conversion to stock form is beneficial, because it will infuse new capital and subject these institutions to market discipline, the decision about whether to convert is left solely in the hands of incumbent management. It is not uncommon for employees and trustees to own as much as 30 percent of the stock after the offering and the exercise of stock options. The stock is free, and--by pricing the options very low, with the help of cooperative regulators and appraisal firms--management can buy stock options at the offering price, secure in the knowledge that pervasive underpricing will enable them to make millions when share prices adjust to true market value.

Because there are no existing owners to protest if the offering price is too low, every conversion presents a danger to the safety of the banking system. If the bank's shares are sold

too cheaply, the bank will be undercapitalized, and unsafe. In response, banking regulations require that no thrift that converts be sold for less than its appraised value as determined by an independent valuation firm.

But how independent are these firms? No firm will stay in business without happy customers. And a firm that makes its appraisals high is not likely to get any referral business. Thus in the past two years, the average bank has experienced a 30 percent increase in share price on the day of the conversion. This one-day return translates into a simple annual return of well over 1,000 percent. It is not uncommon for share prices to rise as much as 55 percent within a week of an offering.

But during the conversion, there is a slight risk that a hostile bidder might appear. This is because, as a vestige of the myth that the depositors own the mutual, the law requires that depositors be allowed to vote on the trustees' decision to convert. If the bank's shares are priced really low, the temptation for other banks to start a bidding war becomes irresistible. Then the trustees of the mutual must turn to compliant regulators for protection from the ravages of market forces.

This is exactly what is happening in the attempt by Green Point Savings Bank of Flushing, N.Y., to convert from mutual to stock form. This deal was very sweet for insiders. The outside appraisal was in line with the appraisals in other conversions. If the stock performs only on average with that of other deals, officers and trustees stand to make about $200 million. In the

first day alone, the 16 executive officers and trustees stand to gain about $21,450,000 from share awards and an additional $7.8 million from options, assuming the shares rise in value by the average amount for deals of this kind.

Competition, in the form of a hostile bid from Republic New York Corp., quickly reared its head. Like Green Point, Republic would contribute only the appraised value of the stock as capital, and thus might get control at a bargain price. But Republic also appealed directly to Green Point's 250,000 depositors, offering to make a special interest payment to those depositors who kept their accounts at Green Point for a year after Republic made its acquisition. It began with an offer of $100 million, and swiftly raised it to $250 million.

At long last it seemed that the free market had come to the mutual conversion racket. But not for long. First, Derrick Cephas, the New York state superintendent of banking, sent a letter to Republic saying that this special interest payment would not be legal if offered to influence the votes of depositors. But it is hard to see how Republic's payment to depositors differs from the premium typically offered shareholders in hostile takeover contests. Moreover, the payment was not made solely to influence votes, but also would serve to retain the loyalty of depositors in the event of a change in management.

Next, the superintendent issued a news release stating that Republic's offer was "illegal and improper" and demanding that it be withdrawn. Not only was there no notice or hearing given to

this determination of illegality, but the superintendent gave no explanation and cited no statute or regulation to support his conclusion. A review of relevant regulations reveals nothing that would support this determination.

The superintendent then launched an investigation of Republic. Of course, one would think that a finding of illegality would come after an official inquiry, rather than before. In addition, the superintendent proposed a major revision of the regulations governing conversions to the New York State Banking Board. These new regulations would prevent outside bidders from appealing directly to depositors for approval of their rival bids. But again, this seems inconsistent with the rule of law.

The superintendent would not be issuing new regulations to cover conduct that was already illegal. So the promulgation of these new regulations suggests that Republic's offer was not illegal when made. The new rules would serve no purpose other than to protect incumbent management from market forces and to prevent mutual depositors from having access to information they need to vote intelligently.

According to the new rules, outside bidders would be able to communicate their offers directly to the incumbent board, but the offerors would be prevented from appealing directly to depositors themselves. Market forces are being quelled for the stated purpose of preventing "pressure from being exerted on thrifts, their trustees, or directors that wish to remain in mutual form," and to establish "orderly procedures" to govern conversions from mutual to

stock form. Trustees of mutuals naturally want their institutions to remain independent from the influence of outside investors, but it is hard to see who benefits other than the trustees themselves.

ABUNDANCE OF CONFUSION

After Republic's bid was declared illegal, it was withdrawn. So, it was hardly surprising when Green Point shareholders, earlier this month, voted to approve the trustees' proposal to convert to stock form. Interestingly, the vote was very close, and in the midst of the proxy solicitation, Green Point was forced to sweeten the pot by offering cash payments in much the same way as Republic had done. But the state banking department put the matter on hold while it conducts an investigation to determine whether Green Point's disclosures were adequate, the appraisal complied with New York law, and the proxy solicitation was fair to depositors.

The result of all this regulatory action is an abundance of confusion. Existing and proposed rules should vigorously encourage mutuals to "privatize" by converting to stock form. In the U.S., which has the world's most highly developed capital markets, control of mutual banks should be determined by market forces, with control going to the highest bidder.

Mr. Macey is a professor at the Cornell Law School

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FDIC Response to Question from Rep. Barrett

The differences between the OTS rules and the rules in Wisconsin that become effective in March or April of this year, are included in a comparison chart attached to the written testimony. With respect to the 25 percent rule question from Mr. Barrett, under Wisconsin law, the aggregate purchases of stock for insiders is limited to 35 percent. That differs from the OTS' rules which use a sliding scale of 25 - 35 percent depending on the size of the institution.

We do not know of any instance in Wisconsin where insiders were permitted to buy more than 35 percent of all shares of stock. However, Wisconsin conversion proposals have permitted insiders to buy more than 35 percent of the stock sold. For example, in the Guaranty Bank, S.S.B., Milwaukee conversion, insiders were permitted to acquire 53 percent of shares distributed but only 25 percent of total shares, with the rest of the shares being held in the holding company. The Mutual Savings Bank in Milwaukee proposes to authorize Class A stock representing 80 percent of the shares and Class B stock representing 20 percent of the shares. However, all of the Class A shares will be held within the holding company and, all of the Class B shares will be allotted to insiders. This means that 100 percent of the shares distributed will go to insiders. OTS rules are silent on transactions of this type where all of the shares are not distributed. However, we are not aware of any OTS transaction, excluding a bailout of a problem situation, wherein insiders were permitted to acquire all of the distributed shares.

STATEMENT OF THOMAS S. JOHNSON, CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF THE GREEN POINT SAVINGS BANK, BROOKLYN, NEW YORK, BEFORE THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND DEPOSIT INSURANCE OF THE HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

Chairman Neal and members of the Subcommittee, thank you for giving me this opportunity to present a statement on behalf of The Green Point Savings Bank, Brooklyn, New York ("Bank"), in connection with the Subcommittee's hearings on H.R. 3615 and the general topic of mutual to stock conversions. I am constrained in my ability to discuss the Bank's recent stock conversion due to pending litigation concerning the transaction. However, I did feel that I could provide the Subcommittee with some insight regarding an issue that has received considerable attention: why a well-capitalized institution such as the Bank would decide to convert to stock form.

The Bank is a community-oriented institution of over $6.4 billion in assets offering traditional deposit and loan products. The Bank specializes in making limited documentation loans. This means that when underwriting the loans, the Bank places greater emphasis than traditional lenders on the value of the properties securing the loan and less emphasis on the income and assets of the borrowers. The Bank lends only on properties located in its market areas and engages in a thorough appraisal process. Its large in-house appraisal staff has a detailed knowledge of local real estate markets. The Bank requires a larger downpayment than do other lenders, but does not require the borrower to provide as much financial data about his or her employment and personal finances. Also, the Bank specializes in small neighborhood mortgage loans to avoid concentration of risk. The average size of new residential loans is approximately

$120,000, and the maximum residential mortgage loan that the Bank will make is $400,000. The Bank also employs careful collection and foreclosure procedures to protect its assets and capital position.

The Bank's lending strategy allows it to make home mortgage loans to people who would not be able to obtain financing from traditional lenders. The Bank is among the largest lenders in the New York area to low and moderate income neighborhoods, to minorities, and to high minority neighborhoods. Indeed, in 1992, the Bank ranked first in home lending in high-minority neighborhoods, first in lending to minority applicants and second in lending in low income neighborhoods in the combined New York and Nassau-Suffolk SMSA's and the New York SMSA individually (see attached charts). The Bank is very good at what it does and has been consistently profitable, generating net earnings of at least $54 million in each of the last five years, including $84 million in fiscal 1993. Our Bank is an example of an institution which serves its entire community, including low and moderate income persons, while achieving strong financial performance and maintaining capital well in excess of required levels.

The new capital raised in our conversion allows the Bank to expand its limited documentation lending program in its current markets even further, while not jeopardizing its capital level. Additionally, our thought was that the success of our limited documentation lending program in the New York City and Nassau-Suffolk areas could be replicated in other parts of New York State and even in other states. In order to implement the program effectively in new areas, it is vital to the Bank that it establish a presence in and become intimately familiar with the real estate markets in those areas. Acquisitions of other banking institutions will probably be the most attractive method of establishing such a presence, and acquisitions of this nature

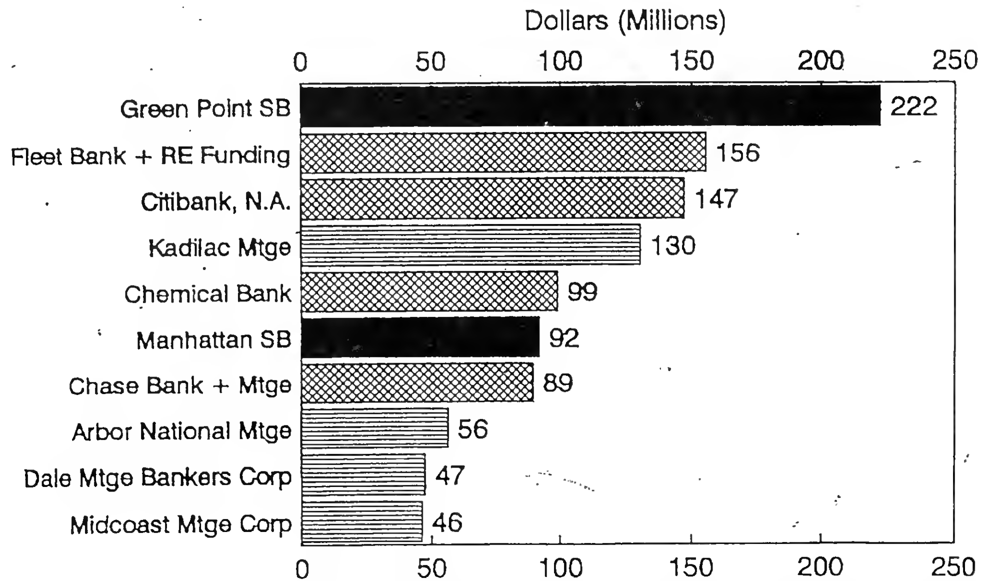
require capital. The new capital raised through the conversion will facilitate the Bank's expansion plans. Additionally, the mutual structure does not lend itself to acquiring other institutions; the stock form provides much greater flexibility. For example, in its new structure as a stock savings bank with a holding company, additional institutions may be acquired and held as separate subsidiaries of the holding company, and stock, in addition to cash, may be offered in acquiring such institutions. Under these circumstances, the conversion to stock was a logical business strategy for the Bank.

Another consideration was that the mutual form is becoming antiquated in the modern financial marketplace. The stock form is employed by all commercial banks, most other business entities and a growing number of savings institutions. Due to stock conversions and Resolution Trust Corporation receiverships, the number of mutual thrifts and their aggregate asset size has declined drastically. Given the Bank's size and the highly competitive market in which it operates, the mutual structure simply no longer made sense.

I might add that the Bank's conversion was quite successful, grossing over $800 million. All of the conversion stock sold to the public was purchased by depositors. The Bank's business plan calls for a variety of programs to benefit its community including enhanced interest payments on certain deposit products and the establishment of an endowed educational and charitable foundation. We certainly believe that the conversion will prove highly beneficial to the Bank, its depositors and other customers and the communities that it serves.

Thank you again for the opportunity to submit this statement. I hope that it is helpful to the Subcommittee.

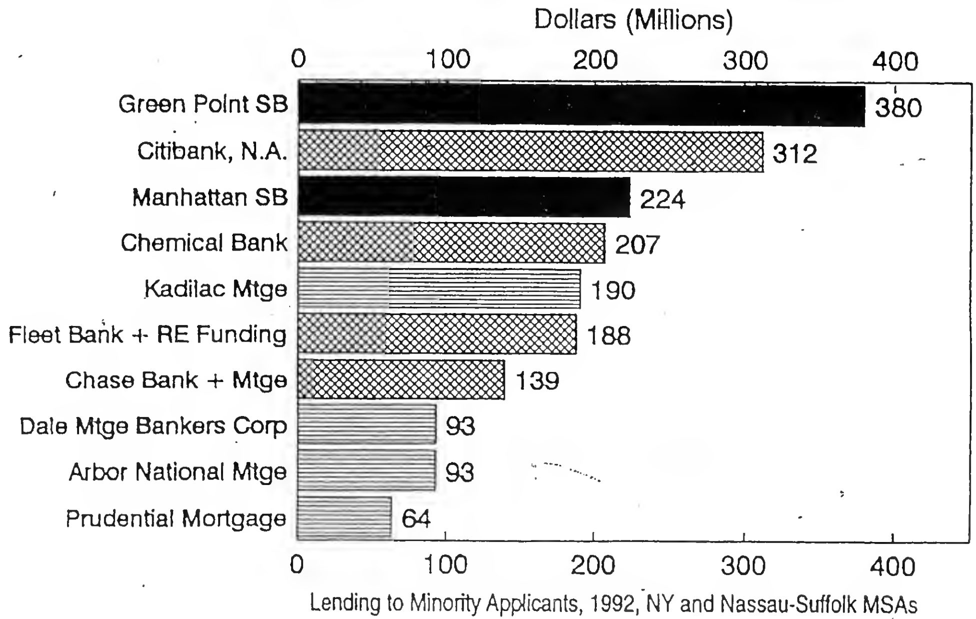
Green Point Ranked First in Home Lending to High-Minority Neighborhoods in the New York Area



Lending in Census Tracts with Over 50% Minority Population, 1992, NY and Nassau-Suffolk MSAs.

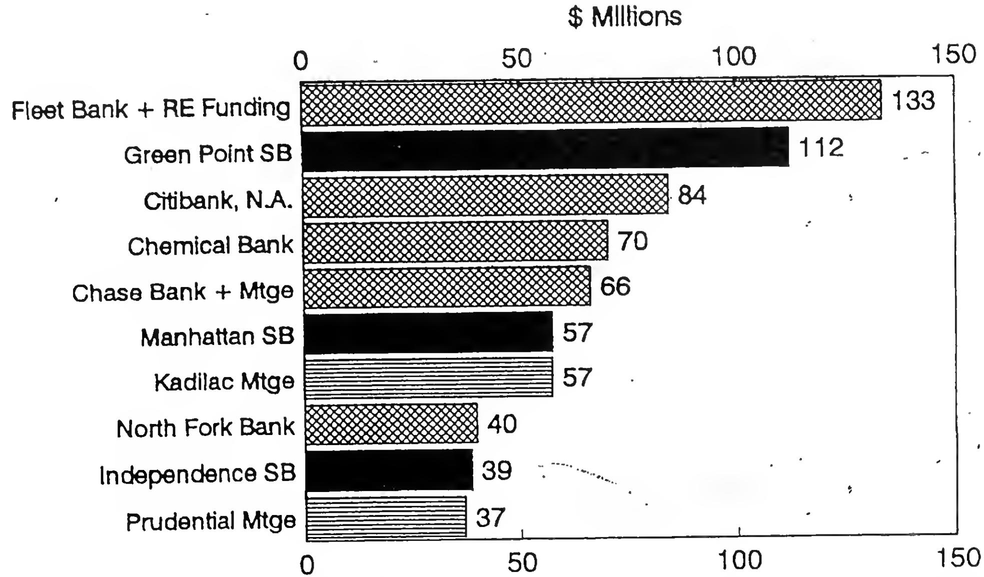
KPMG Peat Marwick

Green Point Ranked First in Lending to Minority Applicants in the New York Area during 1992



Peat Marwick

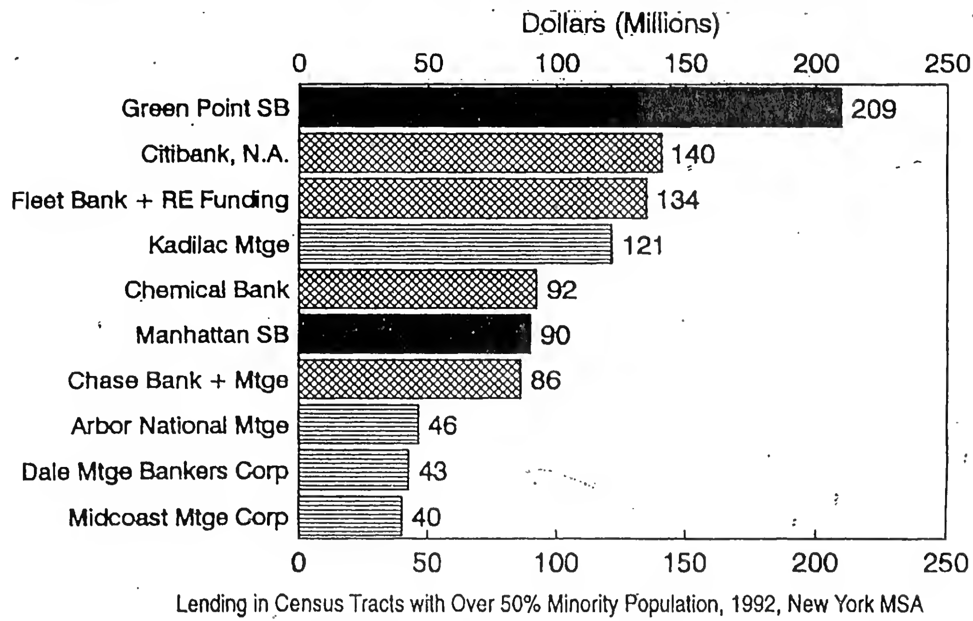
Led by Green Point, Three Thrifts are among the Top Ten Lenders to Low-Income Neighborhoods in the New York Area



Lending in Census Tracts with Median Family Income Less than 80% of the MSA Median, 1992, NY and Nassau-Suffolk MSAs

KPMG Peat Marwick

Green Point Ranked First in Home Lending to High-Minority Neighborhoods in the New York MSA



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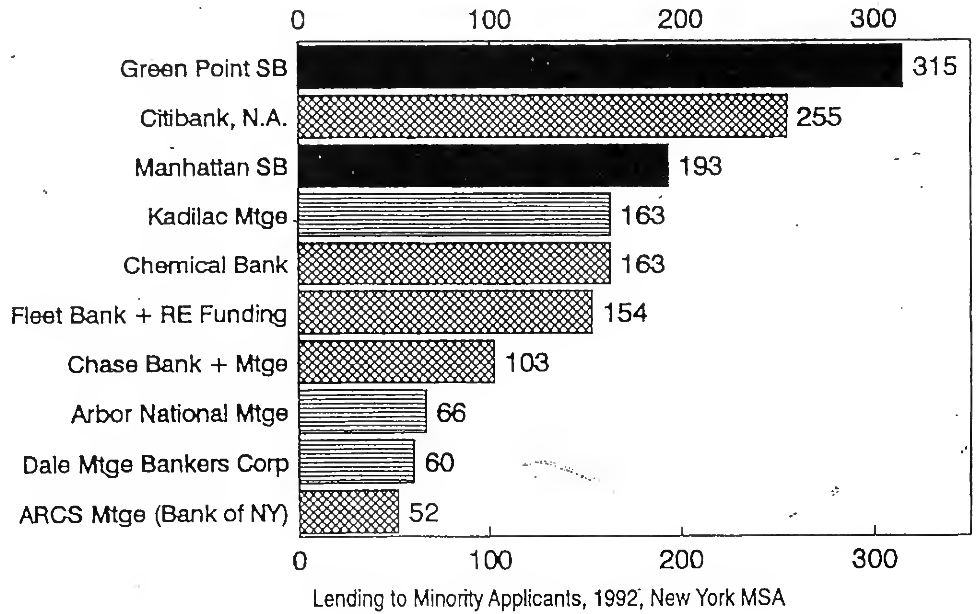

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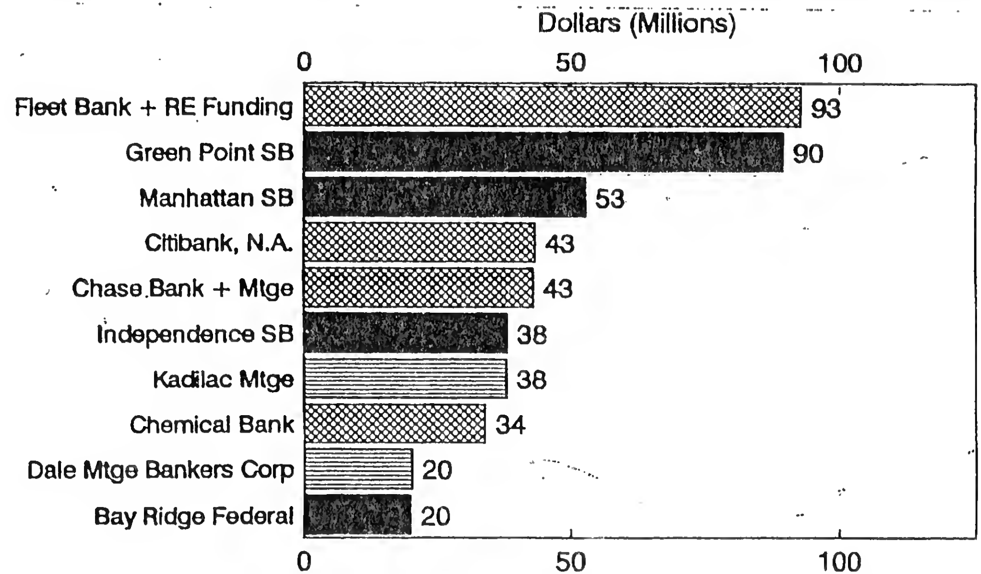
Led by Green Point, Four Thrifts are among the Top Ten Lenders to Low-Income Neighborhoods in the New York MSA



Lending in Census Tracts with Median Family Income Less than 80% of the MSA Median, 1992, New York MSA

KPMG Peat Marwick

ISBN 0-16-044075-0

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